NAPF
Securing the future of pensions

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NAPF response to DP14/03 – discussion on the use of dealing commission regime

The NAPF is the voice of workplace pensions in the UK. We speak for over 1,300 pension schemes that provide pensions for over 17 million people and have more than £900 billion of assets. We also have 400 members from businesses supporting the pensions sector.

We aim to help everyone get more out of their retirement savings. To do this we promote policies that add value for savers, challenge regulation where it adds more cost than benefit and spread best practice among our members.

Our members, as significant institutional investors and customers of the asset management industry welcome the regulatory focus on the use of the dealing commission regime and we share the conclusions reached by the FCA and set out within this discussion paper.

It is our view that the current arrangements contain inherent conflicts of interest that are not likely to be sufficiently overcome by continued regulatory scrutiny or enhanced transparency to clients. Additionally, we suggest that the current arrangements lead to a number of market inefficiencies, such as the limited coverage of the SME sector and the narrow universe from which a majority of investment research is procured. In turn we consider that a move to full unbundling of research from execution at (initially) a European level is desirable and in the interests of the millions of savers who are reliant upon the investment industry for managing their pension savings.

Overview

The effective use of good quality research is clearly of benefit to our pension fund members – the clients of investment managers – as they should benefit from the improved performance emanating from the use of this research in what is a highly competitive market. Furthermore, it is self-evidently in the interests of pension fund clients that there is a competitive research market providing coverage of small and large cap stocks in local and international markets. Efficient markets lower the cost of capital and assist the free movement of capital to where it can be best used, helping drive sustainable economic growth.

Our members however, consider that the current arrangements for the purchasing of investment research via commission payments taken from client funds create an inherent conflict of interest for investment managers.

The use of client money to purchase research displaces what would otherwise be a cost of business for the fund management firm and results in an over-use of and over-supply of external research from a narrow pool of providers which is purchased without the level of rigorous due diligence and oversight that a firm would

apply to spending its own money. This in turn has a potential detrimental impact on the investment returns being generated for clients and ultimately pension beneficiaries.

Few other industries have the luxury of using their clients' money to buy a key raw material in their industrial process making their offering appear cheaper. To the extent that the investment management industry relies on external research it fails to demonstrate that it is not just a substitute for costs that should be borne by the fund manager itself as a cost of doing business.

In the short-term it is essential that there is both improved internal governance of commission spend and enhanced transparency to clients for the use of their money in order that a pension fund can quickly and simply identify the full range of costs borne by their investments and in turn view the net return to them. It should be evident that the research being purchased and utilised directly relates to their specific investment mandate(s) and is thus concentrated on areas where the returns are expected to be generated.

However, while we believe that improved disclosures are necessary and important, we do not believe that better disclosure of dealing commission charges will in and of themselves provide sufficient scrutiny on investment managers to ensure a similar degree of rigour in spending dealing commission as a firm would apply to spending its own money. Even with enhanced transparency an information asymmetry would continue to exist making it difficult for clients to effectively judge the 'value' being attributed to the research being purchased by investment managers with their money.

While we believe that the current proposals with MiFID II are a positive step, we do have concerns that as currently drafted they risk creating further uncertainty and in turn potential regulatory arbitrage. Our pension fund members would ultimately favour a cleaner and more complete unbundling of all research from dealing commission. While we accept that such a significant change would likely have short-term ramifications, it is our view that the resultant market may be more competitive, include more provision from a broader universe of providers and act more transparently in the interests of the end clients for whom the system should be operating. We encourage the FCA to continue to make the case for fundamental reform.

Yours sincerely

Paul Lee,
Head of Investment Affairs
NAPF

Q.1. Do you have any comments on our analysis on the potential impact of unbundling payments for research from execution arrangements, based on MiFID II proposals?

Q.2. Do you have any analysis that would help inform our view of possible benefits or costs of extending requirements in MiFID II to cover all research goods and services?

As the discussion paper outlines UK investment managers currently spend an estimated £3bn of dealing commissions per year to brokers, with around £1.5bn of this spent on investment research. These transaction costs are primarily borne directly by our pension funds members, the customers of investment managers'. This is not an insignificant sum.

We continue to commend the work of the FCA in this area. The issue of the use of dealing commissions by investment managers also rightly features within the FCA's broader review of competition within the wholesale market. As we have indicated within our parallel response to that consultation paper the inherent conflicts within the current arrangements generate an inefficient and opaque market resulting in poor practices and controls by investment firms and subsequently higher costs for end investors and potentially lower pension pots for individual savers.

As outlined with the discussion paper, the current arrangements for purchasing investment via commission payments from client money result in:

- An embedded link between the levels of research payment and trading volumes.
- A lack of rigour being applied in assessing the value of the research services used.
- Opaque and often limited ex-ante pricing resulting in a lack of price transparency in the market for research and a barrier to entry for competitors.
- A vast majority of research being purchased from a narrow universe of providers, eg full service investment banks;
- An over coverage of big stocks and a very limited coverage of SME stocks.

A more competitive market

The current unpriced bundling of research and execution services is commonly cited as preventing transparent price formation and competition based on the quality of discrete research services. This makes it difficult for independent research providers to compete. It also adds to the challenge faced by investment managers when trying to assess the value for money of research.

This lack of a transparent market for investment research has seemingly resulted in a situation whereby at present investment banks are currently the dominant providers of research. However, the World Federation of Exchanges estimates 35-40% of publically listed companies have no analyst coverage. Equally, despite pension funds mitigating investment research by diversifying their portfolios and utilising multiple investment managers, the research that is informing investment decisions is on the whole emanating from a fairly narrow pool of providers – analysis by Frost Consulting suggests that many asset managers buy research from a fraction of the available bundled research universe (let alone the unbundled universe) many of whom have conflicts which have the potential to impinge upon the quality of the research being provided.

With a more level playing field in terms of ex-ante pricing, other providers including independent research providers would be able to compete much more effectively against brokers and product and service offerings would become more diverse. Brokers would have to demonstrate the value added of their own research offering versus more specialist research providers, and would no longer receive research commissions simply due to trading activity. In turn this should stimulate investment managers to view the broader research universe beyond those with execution capacity and tailor their research procurement in a more bespoke fashion.

It should be emphasised that the NAPF does believe that effective use of research can be a very significant driver of investment returns to clients. Our members fully expect that in an environment where the use of dealing commission is more restricted Investment managers would still need to access a flow of investment ideas and should therefore be prepared to pay for value-added external research. This external research should be tailored to the investment approach of the firm or product and would likely include a mixture of bespoke reports and analysis, research on particular instruments or companies, market or sector wide analysis, as well as more generic commentary. It seems perfectly reasonable to expect that payments for these products and services could be operated on a mixture of fixed fees and subscriptions.

An objective of generating a broader market place should prove beneficial in both driving competition and innovation.

Efforts to unbundle commission payments for execution and research should prove a good first step. Requiring asset managers to utilise Commission Sharing Agreements (CSA's) and set annual research budgets which are transparently communicated to clients setting out clearly what services would be purchased and utilised from this budget, and why this is line with the investment strategy, will help focus minds and break down the link with trading volumes.

However, we are of the view that ultimately moving to a fully unbundled system where the costs fall on the asset manager rather than the client - effectively forming part of the annual management charge - is likely to be the most effective mechanism to achieve this objective.

A potentially reduced cost to clients

While there are various elements of the overall costs faced by schemes, and the focus initially has been on the most transparent and largest, attention is shifting to those that are less clearly disclosed. The use of dealing commission is in this respect one of the largest and least transparent costs.

At present, the level of disclosure to institutional clients such as pension funds about commission spend means that it is difficult for them to understand how their money is being spent and how that spending is in their interests. It is difficult for clients to judge the usefulness of the research provided to the investment manager, or to assess whether the amounts spent on external research are reasonable. Customers cannot assess the cost benefit of external research themselves and the value added it represents vis-à-vis the investment managers' own in-house research, nor compare these costs easily between different investment managers (especially if the manager's own 'valuation' process has weaknesses). These challenges would still remain with improved transparency in this area.

We believe in the short-term that there should be:

- Much improved disclosures from investment managers to clients of their policies and processes for utilising dealing commissions and for managing the arising conflicts of interest.

- Enhanced disclosures to clients allowing quick and simple identification of the full range of costs borne by their investments and enabling easy assessment of the net return to them.

However, we recognise that better disclosure of dealing commission charges will still not provide sufficient scrutiny of investment managers. The nature of making payments from client funds mean that firms are unlikely to consistently apply a similar degree of rigour as they would apply to spending their own money.

As the discussion paper suggests, it is unlikely that most investment managers would choose to pay for research based on the 'broker vote' if they were using their own funds. Instead, they would require research providers to set an upfront price for an agreed level and quality of goods and services supplied, which they would review on an ongoing basis. To that end, there is best practice emerging within many asset management firms to seek to bring greater and more oversight to the spending of commissions on investment research such as the setting of finite budgets. This in turn should encourage more providers to set an upfront price for their services. However, while these emerging practices are encouraging, as already alluded to, we do not believe they will succeed in fully addressing the more fundamental underlying issue.

While it has been suggested that investment managers should compete on the basis of the efficiency of their commission allocation, we do not see this as realistic. Instead investment managers should be expected to compete on their product propositions which would likely include the level and nature of their internal and external research capability, without requiring further recourse to client funds.

There is rightly an increasing focus on the level and nature of the costs and charges associated with investment management. In this climate we would suggest that the current model whereby investment research is purchased via dealing commissions remains a model that is unfit for purpose and due for reform.

It is commonly argued that if reforms were introduced which explicitly or in effect resulted in full unbundling then this would simply move the cost for external research from transaction costs into the Annual Management Charge (AMC) and as such there would be no net benefit to customers. The NAPF is however, sceptical of this.

Indeed, if greater due care was given then it would be fair to assume that more value could be gained for less spend. The FCA's conclusion is clear: fund managers are not as careful in spending client assets on commission as they would be if spending their own money. In a world where research was not able to be purchased via commission payments, if costs were poorly managed, the most immediate impact would be on the investment manager's bottom line and not on their customers' funds.

It appears a reasonable supposition that detaching research payments from execution arrangements would cause investment managers either to bear the costs directly, to find efficiencies in their research consumption, or reflect these costs in more visible headline charges (such as the AMC). This may mean that AMCs will be higher, at least in the short-term. The more transparent visibility of the costs however, will also enable pension funds to negotiate fees and create a more level playing field. In turn this is likely to result in investment managers applying much more scrutiny to research spending, and seeking to maximise value for money to justify the value-added benefit obtained for their customers.

As such we would hypothesise that in a fully unbundled environment, the level of research spend may remain consistent but become more transparent; alternatively the research spend may reduce but become better tailored and focused and in turn generate better value.

Market impact

A truer, well-functioning research market based upon explicit pricing would permit informed decisions to be made about the relative value of each type of product and provider and of the investment manager's own research capability and ability to extract value added from the research. External research pricing would allow better comparison with the cost and value of internal research teams and should diminish the over-supply and over-consumption of research. Clearer sight of the investment manager's internal and external research sources should enable a better understanding of their investment approach, including whether an appropriate range of research is being utilised to inform their investment decisions.

The NAPF is of course not naïve to the significant impact that a move away from purchasing investment research via commissions could have on the research market. There *could* be an impact upon:

- The competitiveness of firms with vis a vis the US and Asia;
- The level of competition within both the investment management and research market;
- The breadth of coverage of stocks, especially with respect to SMEs;
- An increased cost of external research provision for smaller firms which are currently cross-subsidised;
- An inability to purchase research from US providers.

Our view is that while these concerns are genuine their likely impact is difficult, if not impossible, to properly assess. Recent trends already indicate that the market is responding to the attention being directed on the issue by the FCA with new and innovative providers entering the market, however, the tax-treatment of unbundled research continues to pose a barrier to catalysing wider competition.

The nature of the investment industry is increasingly global and in this content the UK is rightly proud to be a global centre for asset management. It is desirable for any significant reform to be taken forward with the highest level of international agreement that can be found. In this context, we continue to applaud the FCA in providing focus on this agenda and taking the lead in pushing for reform at an EU level through MiFID II and internationally through IOSCO.

In general our pension fund members are of the view that if significant reform were to be introduced at least at an EU level then the most significant impacts would likely be short-term and the market would in relatively short-order adjust. The resultant market would in turn be more competitive, include more provision from independent and other providers and act more transparently in the interests of the end clients for whom the system should be operating.