



UNBUNDLING AND SOFT COMMISSIONS DISCLOSURE ARRANGEMENTS FOR APCIMS MEMBERS

Appendix 1 of PS05/9 sets out the new rules which will apply in place of the current soft commission rules to firms' arrangements for disclosing any execution/research services received from third parties in return for dealing commissions. The rules will take effect on 1 January 2006 with a limited six-month transitional period during which firms may continue to use existing soft commission agreements.

The new regime limits the types of goods/services which a firm may receive in return for paying dealing commissions on customer transactions to third party brokers. Under new COB 7.18.3R, the only types of goods/services which may be received by a firm in such circumstances are those relating to the execution of customer orders and those comprising "genuine" research. All other benefits (computers, dedicated phone lines, seminar fees etc) are classified as "non-permitted services" and must be paid for separately by the firm itself.

Besides restricting the goods/services which may be received in return for dealing commissions, the new rules require investment managers to provide enhanced information to their clients on such goods/services and their costs. In its discussions with the FSA, APCIMS has emphasised that disclosure solutions developed for institutional fund managers are unlikely to be appropriate for business undertaken with private customers and small intermediate customers (e.g. small charities and trusts). Consequently, with the FSA's knowledge, APCIMS has produced this paper to assist those of its members who are affected by the new regime.

Application of the new regime

As paragraph 3.20 of CP05/5 makes clear, the FSA's "proposed rules apply only to arrangements where an investment manager receives execution or research goods and services from brokers and other firms which are paid for by way of a commission charge". This statement is given effect via COB 7.18.3R and COB 7.18.10G and means that the new rules do not apply –

- "to execution and research generated internally by an investment manager itself"; or
- where the investment manager absorbs charges from third parties for execution/research and charges its clients on the basis of pre-advised rates, which might be on the basis of an "all-in" fee, covering management, dealing and administration costs or on a fees and commission basis.

Consequently, an APCIMS firm will only have to comply with the new disclosure provisions if it is party to an arrangement which has the characteristics set out in COB 7.18.3R(2), namely -

- (a) the firm executes transactions for its clients through a third party broker; and**
- (b) the firm passes the charges levied by the third party broker directly to its clients for payment (i.e. charges are not absorbed by the firm); and**
- (c) in return for the charges referred to in (b) above, the firm receives a good or service – over and above pure trade execution – which either relates to trade execution generally (and meets the criteria set out in COB 7.18.4E) or comprises the provision of research (and meets the criteria set out in COB 7.18.5E).**

So far as (a) above is concerned, third party execution is likely to occur in scenarios where -

- the firm acts solely as an investment manager, i.e. it is not a member of the LSE and must, therefore, use the services of third party brokers for trade execution; or
- the firm is a LSE member but in certain circumstances uses the services of a third party broker (e.g. using an overseas broker for trade execution in non-UK securities).

So far as (c) above is concerned, under COB 7.18.5E, there are various criteria which research provided by a third party must satisfy if its provision is to be regarded as an arrangement falling within COB 7.18.3R. In particular, research must be “capable of adding value to the investment decisions by providing new insights that inform the investment manager when making investment decisions about its customers’ portfolios”. Where a firm values and makes use of research material received from third party brokers and the arrangement meets the criteria set out in COB 7.18.3R(2), as noted above, it will generally be required to comply with the new disclosure requirements in respect of execution and research services received. In such cases, a firm may wish to consider the costs of identifying/disclosing how dealing commissions are split between pure trade execution and research vis-à-vis the value of research received, to determine whether the arrangement is cost-effective.

However, APCIMS is aware that some firms falling within (a) and (b) above may receive research from third party brokers which they neither want nor use – in such a scenario, a firm may be able to claim that it is not a party to an arrangement of the type outlined in COB 7.18.3R on the basis that the research which it receives does not in fact add value to its investment management decision-making process. However, such a claim will only be feasible if a firm genuinely makes no use of the material it receives from third parties and its fund managers place absolutely no reliance upon it when acting for their clients – e.g. in scenarios where such research is provided only intermittently or forms part of the third party’s general marketing material or where it is automatically discarded upon receipt without being passed to the firm’s fund managers or research staff or where the firm has asked for such material not to be provided.

The IMA Disclosure Code – an appropriate standard for APCIMS firms?

COB 7.18.12R requires an investment manager to make “adequate disclosure” to its customers of any arrangements that it has for the receipt of execution/research services which fall within the parameters set out in COB 7.18.3R(2). COB 7.18.14G(2) goes on to state that, in assessing the adequacy of such disclosures, the FSA will have regard to the extent to which investment managers adopt standards developed by industry bodies such as IMA, NAPF and LIBA.

The Code developed by IMA and NAPF requires two levels of client disclosure:

- Level 1 disclosure, provided annually, will describe the investment manager’s policies and procedures as regards the management of costs paid on behalf of clients; and
- Level 2 disclosure, provided at least six-monthly, will provide both client-specific and firm-wide information on how commissions paid have been generated/used.

In discussing the new regime with the FSA, APCIMS has argued that disclosure at the level recommended by the IMA Disclosure Code is not appropriate for firms dealing with private and small intermediate clients because of (i) the extensive information which such clients already receive on charges; (ii) the fact that additional disclosure would not enable such clients to exert pressure on transaction costs and (iii) the significant potential costs for firms in providing such information.

The FSA recognises these concerns and, although it expects that “the IMA Disclosure Code will become the standard means of disclosure of commission spend for UK institutional and retail funds”, it makes clear in paragraph 2.8 of PS05/9 that **“there may be circumstances in which it may not be the most appropriate means of disclosure: for example, in relation to private client mandates where the proportion of commission paid to third party brokers is small. The rules provide sufficient flexibility for investment managers in these cases to adopt alternative means of meeting their disclosure obligations provided they can show that the level and content of disclosure to their clients is sufficient and appropriate. The disclosure required under COB 7.18.12R could be included with other information provided to private customers such as periodic statements.”**

Disclosure by APCIMS members

Given the above, a variety of different approaches may be suitable for the relatively small number of APCIMS members whose business arrangements, or a sample of those arrangements, fall within the new disclosure regime. For example –

- some firms may decide that compliance with the IMA Code is the appropriate standard for certain elements of their business (e.g. if a firm has significant amounts of institutional business or relies heavily on research provided by third party brokers); or
- some firms may consider that, while they do have certain activities to which the disclosure provisions will apply, a less prescriptive approach than that set out in the IMA Code will be appropriate and acceptable to the affected clients (perhaps, a statement of the firm’s general policy in this area with figures disclosed at a firm or group level from time to time, together with the general disclosure of charges noted below and detailed in the Appendix); or
- some firms, whose activities are only marginally caught by the new rules (e.g. where a firm makes only occasional or limited use of research received from third party brokers), may wish to consider whether the disclosures of charges which they already make to their clients are sufficient to ensure compliance with the new requirements.

To assist firms in coming to a conclusion on the level of additional disclosures, the attached Appendix identifies the existing relevant Handbook provisions relating to disclosure of charges and gives examples of the ways in which firms currently comply with them.

More specifically, firms whose trade execution arrangements fall within the COB 7.18.3R parameters, may wish to consider the following points –

- the rules place no specific obligation on third party brokers to provide their investment manager counterparties with information as to how their dealing commissions should be split between pure trade execution costs and the costs of other execution/research services, but rely instead on industry-developed solutions. Firms should be aware, therefore, that the London Investment Banking Association (LIBA) has issued a Statement of Good Practice to its members suggesting that they should work with each of their fund manager clients to agree “an indicative forward-looking split between research and execution components of commission that will be applied to the relationship between that broker and that manager”. Although the LIBA Statement refers only to its members’ relationships with IMA members, it is possible that APCIMS firms may be able, by referring to the Statement, to obtain indicative research/execution splits from their third party brokers. If this is not possible, private client firms might wish to set their own in-house disclosure standards in relation to how third party costs should be split for disclosure purposes in the light of figures being used elsewhere in the investment management industry.
- concerns have been expressed that clients might interpret new disclosures in relation to the use of dealing commissions as notification of a firm’s charges being changed/increased – consequently, firms will need to word their disclosures carefully so as to make clients understand that it is only the method of disclosing certain charges that is changing and not the charges themselves.

- in some circumstances, firms may wish to fulfil their disclosure obligations via their standard customer documentation. Although disclosures will undoubtedly vary between firms, any wording added to terms of business for this purpose would need at a minimum to identify the nature of the business effected via third party brokers, the way in which such third parties' dealing commissions are split between pure trade execution and other execution/research services (i.e. by using an in-house standard as per the first bullet above) and how any execution/research services paid for in this way are used by the firm to the benefit of the client.

Obviously, there is considerable variation in firms' practices in relation to trade execution and to the disclosure and management of charging arrangements. Bearing this in mind, together with details of any execution/research services received, it will be the responsibility of each firm affected by the new regime to decide upon and justify a level of disclosure which is appropriate to the needs of its own particular client base.

The information contained in this communication is provided only for general information purposes for APCIMS members alone; it is not intended to be a comprehensive study and should not be relied on in, or treated as a substitute for specific legal or financial advice on, individual situations.

APPENDIX

Disclosure of charges - existing Handbook requirements

Existing Handbook provisions relating to the disclosure of charges include –

- **COB 4 Annex 2E(6)** which requires a firm to include in its terms of business or customer agreement “*details of any payment for services payable by the customer to the firm including, where appropriate, (a) the basis of calculation;*” and “*whether or not any other payment is receivable by the firm in connection with any transaction executed by the firm with or for the customer in addition to or in lieu of any fees*”.
- **COB 4 Annex 2E(14)** which requires a firm to include in its terms of business or customer agreement “*the prior disclosure required by COB 2.2.16R*” where it has a soft commission agreement in place with any person with or through whom transactions are effected. [This provision will be replaced by equivalent wording referring to COB 7.18.12R.]
- **COB Appendix 1.1(6)** which requires a firm to include in terms of business and other documents relevant to business undertaken by distance means information on “*the total price to be paid by the customer to the firm for its services, including all related fees, charges and expenses or, where an exact price cannot be indicated, the basis for the calculation of the price enabling the customer to verify it*”.
- **COB 8.1.3R** which requires a firm executing a deal for a customer to send him “*a written confirmation recording the essential details of the transaction*” including, under the requirements of **COB 8.1.15E**, information on “*the remuneration of the firm distinguishing (a) the amount of any commission charged; (b) the basis on which the commission has been determined*”
- **COB 8.1.6R** which allows for confirmations not be sent in certain circumstances (i.e. when agreed with the customer or when the firm is acting as an investment manager) but only if, under the requirements of **COB 8.1.7R**, “*any periodic statement which the firm provides to the customer in accordance with COB 8.2 contains the information that would have been contained in a confirmation despatched in accordance with COB 8.1.3R relating to the transactions executed during the relevant period.*”
- **COB 8.2.4R** which requires a firm to provide periodic statements to certain types of customers (i.e. those for whom it acts as investment manager or for whom it administers an account/portfolio) which, under the requirements of **COB 8.2.12E**, cover details of the firm’s charges and remuneration including “*if not previously advised in writing – (a) a statement of the aggregate charges of the firm; and (b) a statement of the amount of any remuneration received by the firm from a third party in respect of the transactions entered into, or any other services provided for the portfolio.*”

Disclosure of charges - examples of current practice among APCIMS members

While the charges levied and the mechanisms for calculating/collecting such charges may vary between firms, it is undoubtedly the case that firms providing services to private clients (unlike firms whose business is concentrated on the institutional sector) are already subject to detailed disclosure requirements which ensure that their charges are transparent to their clients. Set out below, by way of illustration, are examples of some of the ways in which APCIMS members comply with the existing requirements for disclosure of charges to clients –

- Firms generally comply with the COB requirements in relation to terms of business by –
 - (i) including in the main body of their customer documentation standard wording about their charging policy – while this is unlikely to be specific as to amounts, it may well cover administrative matters (e.g. the firm’s arrangements for amending its charges, when and how charges are levied, when and how charges are deducted from client accounts, the issuing of invoices for fees and how clients should pay them) as well as disclosures of general business practice (e.g. whether the firm shares any of the charges it receives with persons who have

introduced business to them or persons who act as the client’s agent in some way, whether the firm receives commission from parties whose products it may advise on).

- (ii) setting out their detailed charges in schedules which may either be included in the main body of their customer documentation or be attached according to the appropriate service type. These schedules tend to cover all of the charges which a firm might levy in the course of its relationship with a client – e.g. management fees, dealing commissions, handling charges, loan arrangement fees and interest charges, safe custody charges, foreign exchange charges and fees levied for handling queries from professional advisers, for preparing valuations for probate/inheritance tax, for providing indemnities for missing stock certificates.
- Charges schedules are often (if not, generally) produced separately from the main body of firms’ terms of business as this enables the firm -
 - (i) to update/amend them by notice according to the terms of its standard documentation (e.g. a firm might write to its clients giving notice of its intention to amend its charges in a specified number of weeks/months with effect from a specified date) without the inconvenience of amending customer documentation which may require the customer’s agreement;
 - (ii) to clearly distinguish between the different types and levels of charges that may be levied for different service categories;
 - (iii) to use them in other contexts – e.g. schedules may be included in the firm’s corporate brochure where its various services are described or displayed on a firm’s website as a form of permanent “shop-window” or used in the course of client visits when account managers are explaining the firm’s charges.
 - Firms generally comply with the COB requirements in relation to written confirmations by sending a contract note in relation to each transaction effected for a client – as well as setting out details of the transaction itself, explanatory text may highlight situations where commission has been shared with or received from third parties or where auxiliary charges have been levied. One example of the latter might be where a firm executes a trade in a non-UK equity using the services of an overseas broker – while some firms may levy a “handling charge” which has been disclosed to/agreed with the customer via its charges schedule for such transactions, others may agree more generally with the client that any “broker charges” levied by the third party will simply be passed on to the client.
 - Some clients do not wish to receive contract notes for each transaction and may request the firm not to send them either generally or in specified circumstances. In such instances, a firm will need to be able to demonstrate (i) in relation to investment managed clients, that it has taken reasonable steps to determine that the customer does not wish to receive confirmations and (ii) in relation to private clients generally, that the client has agreed in writing to not receiving contract notes. In complying with the requirement to provide details of all such transactions via the client’s periodic statement, a firm may prepare a separate transactions schedule or may simply provide copies of whatever confirms may have been automatically produced by its own systems at the time of the individual transactions.
 - Firms generally comply with the COB requirements in relation to periodic statements by sending clients bi-annual portfolio valuations – for some clients, these are a standard part of the overall service they receive from the firm, while for others, they are an optional extra which gives rise to an additional charge. In preparing portfolio valuations, firms may, in relation to each individual constituent of the portfolio, indicate the nature and level of their fees – some investments may be subject to higher levels of fees than others, some may be subject to ad valorem fees and others to flat fees and some may be excluded from the fee calculation altogether (e.g. packaged products where the firm has received remuneration from another source). As well as containing an investment-specific breakdown of fees, a portfolio valuation may contain a summary sheet or invoice showing the overall level of the firm’s charges, any resulting VAT liability, the period to which it relates, the due date for payment and the arrangements for payment.