

May 2005 / Issue 8

A legal update from Dechert's Financial Services Group

Proposed U.K. Rules Call for Radical Cutbacks in Permissible Soft Commission and Bundled Brokerage Services

The Financial Services Authority ("FSA"), the U.K. regulator, is very close to finalizing its new "soft commission" and "bundled brokerage" regime. The new rules represent radical cutbacks in permissible soft commission and bundled brokerage services.

Its latest paper on the subject, published last month, stated that it will introduce the new rules in the fall and indicated that there will be a six-month transition period for firms to update their procedures.

U.S. regulated investment managers and broker-dealers will find these developments of particular interest for several reasons:

- The FSA's approach may be a harbinger of regulatory developments in the U.S. The Securities and Exchange Commission (SEC) and National Association of Securities Dealers are reviewing U.S. soft dollar regulation. A senior SEC staff member stated at a recent conference that the SEC staff is consulting with the FSA on this matter and that he is impressed by the FSA's efforts.
- The rules may impose significant burdens on U.S. broker-dealers trading for U.K.-regulated investment managers. The paper does not exempt U.K.-regulated investment managers trading with U.S. broker-dealers from the requirements that they limit the research and services they obtain and receive a "price breakdown" when research and execution services are bundled.
- U.S. market participants with FSA regulated affiliates or operations will need to review their practices on a global

basis to bring them into compliance with the rules.

- U.S. investment management firms that use traders at their U.K. affiliates to effect trades in the U.K. and elsewhere will need to determine how to handle the U.K. desk's increased obligations under the new rules.
- Multinational businesses will need to pay particular attention to soft dollar arrangements among affiliates that result in the U.K. regulated entity complying with the rules in form, but which might be seen as non-compliant in substance when arrangements involving non-U.K. regulated entities are considered.

The FSA consultation process is in its closing stages. For managers and others who have concerns, now is the last opportunity to comment on the rules before they are finalized. The deadline for responses is May 31, 2005.

Background

In May 2005, the FSA issued a Consultative Paper (CP 05/5 - "Bundled brokerage and soft commission arrangements: proposed rules") that set out the FSA's final proposals in some detail. In summary:

- Research and execution only: Investment managers will be able to buy only execution and research services with clients' funds.

- **Scope of permissible execution:** To qualify, execution services must be linked to the arranging and conclusion of a specific investment decision and the time at which the transaction is concluded, and provided between the time when the manager makes the investment decision and the completion of the transaction.
- **Scope of permissible research:** Research is defined as material which is capable of adding value to investment decisions by providing new insights to inform investment managers when making investment decisions for customers' portfolios. It should represent original thought (not a mere repetition or repackaging of other material) and have intellectual rigor (not a mere statement of the commonplace or self-evident).
- **Value of services:** Both execution and research services must assist the manager in providing its services to customers and not impair the manager's duty to act in its customers' best interests.
- **Examples of non-compliant goods and services:** Examples of goods and services which do not qualify under the above tests are:
 - Services relating to valuation or performance measurement
 - Computer hardware
 - Dedicated telephone lines
 - Seminar fees
 - Subscriptions for publications
 - Travel, accommodation or entertainment costs
 - Office administrative computer software
 - Membership fees to professional associations
 - Purchase or rental of standard office equipment
 - Employees' salaries
 - Direct money payments
 - Publicly available information
 - Custody services other than services that are incidental to the execution of trades.
- **Price break-down requirement:** Managers will have to provide clients with clear information about the separate costs of execution and research being paid for by them before commencing the provision of services, and at least once a year thereafter. The disclosure must include details of goods or services that relate to

the execution of trades and, where appropriate, separate identification of goods or services attributable to the provision of research. The FSA does not intend to provide any more specific guidance as to how the separate costs of execution and research should be calculated, leaving industry participants to reach their own determinations.

Over the next six months, the FSA plans to develop performance indicators to determine whether its proposals are achieving the desired outcome. It also plans to continue discussions with the SEC staff.

Method of Disclosure

Two U.K. trade groups, the Investment Management Association ("IMA") and National Association of Pension Funds ("NAPF"), have revised their model pension fund disclosure code to address the new disclosure requirements imposed by the new rules. The FSA views this effort as a model, although it recognizes that the code has been designed for institutional pension investors and may not be appropriate or practical in other situations. The revised code contains two levels of disclosure.

Level One: A description of the managers' policies, processes and procedures in the management of costs paid on behalf of clients; the disclosure to be made on inception and annually thereafter. This includes describing the firm's policy on external research and how it is purchased.

Level Two: A semi-annual client specific report on

- The commission payments generated on the client's account and the rates at which they are charged;
- How the commissions have been used, including as split between commissions spent on execution on the one hand and research on the other;
- A disclosure of equivalent information on a firm-wide basis.

Managers who do not use the model will need to be able to demonstrate why they think their own disclosure is adequate. While the FSA has acknowledged that it cannot compel overseas brokers to provide information on components of commission, it expects U.K.-regulated investment managers seeking to manage conflicts for their clients to ask for information on the split between execution and research services as they would for U.K. brokers.

International Implications for Managers and Brokers

The regime makes no apparent concession to different practices in overseas markets, though in fairness to the FSA it appears to have received minimal representations on this topic. Therefore, it appears that U.K. managers will need to limit the non-execution services provided to them by non-U.K. brokers, and require those brokers to give them a price breakdown where research and execution services were bundled. The following issues will need to be kept in mind:

- The new rules will only have direct application to U.K.-authorized firms. The mere fact that a non-U.K. manager has U.K. clients will not bring it within the regime. Where non-U.K. firms have U.K. affiliates or branches, these U.K.-based operations will be subject to the new regime. Note also that the regime applies to all U.K. investment managers and not just managers of UCITS and other retail funds.
- U.K. investment managers will have to require brokers to provide them with cost breakdowns which meet U.K. disclosure requirements. It appears that they will also need to ensure they are not provided with any bundled or soft services other than research. In this regard, note in particular that certain standard U.S. soft dollar

services are not compatible with the new U.K. requirements.

There is no indication as yet of how the market will move to address this. What will happen, for instance, if a U.S. broker simply charges the same commission but ceases to provide the prohibited services? What if prohibited services are received elsewhere in an international management group and the “benefit” of those services filters through in some way to a U.K.-regulated group member?

- From the broker’s view, both U.K. and overseas brokers will need to limit bundled services and provide pricing breakdowns for the execution and research components in their commissions to U.K.-regulated investment managers.

Investment managers that execute through proprietary dealing desks in different jurisdictions may have to address similar issues to those described above. A manager’s dealing desk in New York may have to treat orders from U.K. affiliates differently from similar orders received from non-U.K. affiliates.



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