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## Commission Issues In The UK Market

By: Todd Burns

The IMA (**Investment** Management Association, UK) Disclosure Code is now widely accepted as the industry standard for the reporting of brokerage commissions and how they are split between research and execution. The disclosure code is in response to the FSA's (Financial Services Authority, UK) objectives in directing managers to increase transparency and lower trading costs. Lynch Jones & Ryan (LJR) has supported and continues to support in full the efforts of the regulators, **legislators**, trade associations, and market participants in the progress that has been made to date in providing greater transparency of brokerage costs.

However, the way in which the Disclosure Code has been translated and implemented throughout the **investment** management industry leads us to believe that there is still considerable opacity surrounding the generation and use of commissions and confusion interpreting the new disclosure requirements.

Thus far, there is a clearer understanding of the cost of execution; we still know very little about the cost of research or reason for choice of research provider. We have certainly seen commissions level out within the UK market and believe there is a consensus that a full service commission will cost between 15 bps and 20 bps – with five to eight bps for execution and the remainder for research. It is this larger portion of the commission that still lacks clarity in its reporting. There remains much room for improvement on the reporting of how and where this component of the commission is spent and, most importantly, why it is spent.

Although there is a requirement for information on participation in commission recapture programs in the Level 1 disclosure, this has not been fully followed through into the Level 2 disclosure where there is no specific reference to such programs. While disclosure of the details of such programs is arguably covered by the general heading of commission payable "at other rates," there is no direct requirement or pressure on managers to disclose accurately, or on a comparative basis, the precise benefit to underlying clients resulting from participation in commission recapture programs.

### Enhanced Disclosure

It was originally expected that the enhanced disclosure under the new rules would ultimately lower the cost of trading. So far, we have seen little evidence of this. The investment managers and brokers seem to have negotiated lower blended rates (11 bps in some cases), but this is commonly among the larger managers. In the majority of cases, the funds were paying between 15 and 20 basis points before the new rules were implemented and are paying exactly the same now. The only difference is that it is now clear what the cost of execution is. Unfortunately, this remains a small proportion of the funds' overall commission bill.

Further, in reporting the purchase of research, the Disclosure Code could never attribute the cost of individual pieces of research or pieces of 'original thought' to the equivalent value in performance of a fund. There is still no delineation or description of services or proprietary research purchased. Let us be clear about the FSA's definition of research:

- It needs to be original thought.
- Research should be a critical and careful consideration of new and existing facts.
- It should have intellectual rigor; not merely stating what is self-evident.
- It needs some form of proprietary analysis or manipulation of data to reach meaningful conclusions.

We believe that if a clear description of the value and services rendered from these commissions is not articulated, the pension fund client is not getting the true benefit.

### Brokers' Response

The brokers' response to unbundling has been to create Commission Sharing Arrangements (CSAs). Cash from a manager's trading builds up in the CSA and can then be used at the manager's direction to pay for research, either proprietary or third-party or both. In light of the number of Commission Sharing Arrangements (CSAs) that have now been signed, brokers are simply resigning from commission recapture programs as it is economically more attractive to manage a 'soft commission program' as opposed to a commission recapture program. The tangible benefits (the commission) are kept within the manager / broker relationship. Brokerage firms have had their business scrutinized as a result of the Consultation Paper 176 (Bundled Brokerage & Soft Commission Arrangements, FSA) debate and are now showing some resistance to any attempts to substantially reduce commissions.

Where managers are negotiating substantially lower commission rates, there may not be room for commission recapture, but examples of this are few.

Commission recapture addresses inefficiencies in the way commissions are decided upon and spent. If those blended rates fall or if provision is made for the fact that, rightly, some trading should be done at an execution only rate, then commission recapture no longer applies and the inefficiencies it set out to counter-balance have been addressed.

### **Evidence Of Targets Falling**

In our discussions with the investment management community, there is at least one consensus of opinion – commission recapture targets are becoming increasingly harder to meet. In some cases, this is because managers have lowered their full service commission rates. Others, however, have made no change or, more commonly, their brokers have indicated that service levels would fall if rates were reduced.

However, the primary concern facing managers who want to meet recapture targets for their client is that they are unable to facilitate the business with their preferred brokers as they have resigned from commission recapture networks or, in the majority of cases, have produced an 'exclusion' list which prohibits some, but not all, managers from directing orders. This has led to the brokers 'cherry-picking' the business they want, to the disadvantage of those managers with less order flow and, ultimately, their clients.

### **Impact Of CSAs**

We think that in common with old style soft commission agreements, there remains a fundamental 'incentive misalignment' present in the case of CSAs. The CSA segregates execution from research, but it does nothing to address whether the manager is 'purchasing' the appropriate amount of research, receiving optimum value, or, of course, whether that research is adding any value to the investment process.

The FSA considers the distinction between an old style soft commission agreement and a CSA to be that the manager is not forced to put a particular level of commission flow through any particular broker. The fundamental issue is that there is no incentive for the manager not to over-consume research or to consider adequately how much value the research adds.

In any event, even though there is no legal requirement, there appears to be an unwritten rule that reward is given in increased order flow. The basic problem is the classic 'principal/agent' one that the agent (in this case, the manager) has insufficient incentive to minimize inappropriate consumption of research as the underlying client is paying for it. The indirect effect on fund performance is too blunt to provide a sufficient incentive not to over-consume research.

### **The Accrual Of Commission**

An additional problem with CSAs is that if too much commission is allowed to accrue, circumstances whereby cash remains on balance unused could result. We question how this residual cash balance will be accounted for. From meetings with the investment management community, our findings show mixed opinions.

Some investment managers say it will be left with the broker as additional reward – that it has already been paid and is the brokers' responsibility. Some managers seem to think that the FSA's client money rules state that commissions are owned by the broker, unless they are ordered to pay it to a third-party.

Others suggest it might be rolled over to the following financial period. We believe that if there is a balance of cash generated through trading that is not used for the purposes of execution or the purchase of research, it should be returned to the fund.

### **An Alternative Solution**

In light of the limits, to the extent to which CSAs solve the problems identified with regard to soft commission arrangements, proactively managed Commission Recapture programs have a valid and important role to play as a definable benefit to pension funds. We would like to see recaptured commissions reported fully as part of the Disclosure Code. This would account for the possibility that there may be overspending on research and would address any uncertainties surrounding the interpretation of permitted services payable with commissions. It would also return any monies remaining on balance, unused, back to the fund whose assets they are.

The fundamental point about Commission Recapture is that it does not create a conflict of interest between the pension fund and its investment manager as the fund benefits directly from the commission rebate.

Overall, a proactively managed commission recapture program, working alongside a well-administered CSA, is the best way to ensure excess commissions do not accumulate on account with the broker and that managers do not overspend on unnecessary research. In doing so, this gives pension funds real control in managing their commission budgets and expectations that they otherwise have no knowledge of at the outset and little control of throughout the management process. ■

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