

January 5, 2006

Mark Glibbery  
RPD-CIS Policy  
The Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

**Re: CP05/13, Consultation Paper on Bundled Brokerage and Soft Commission Arrangements for Retail Investment Funds**

Dear Mr. Glibbery:

The Investment Company Institute<sup>1</sup> welcomes the opportunity to comment on the FSA Consultation Paper on bundled brokerage and soft commission arrangements for retail investment funds. We recognize that these arrangements—which we will refer to in this letter as “client commission arrangements”—raise complex policy and practical issues that have been the subject of widespread debate and divergent opinions for many years. The Institute and its members are very interested in this important topic and are committed to ensuring that client commission arrangements operate in the interests of investors.

We wish to take this opportunity both to respond to the FSA’s consultation and to express our views generally on the issue of separating or separately disclosing the execution and research components of client commission arrangements (“unbundling”). The Institute supports the FSA’s efforts to narrow and more clearly define what types of services may be obtained by fund managers through client commission arrangements. We have serious concerns, however, with the FSA’s approach of mandating unbundled disclosure by investment fund managers without also requiring brokers to provide unbundled information to fund managers. We believe that the requirement to provide unbundled disclosure could subject investment managers to significant liability risks without generating meaningful information for investors.

*Permissible Uses of Client Commissions*

The Institute strongly supports improving investor awareness and understanding of fund fees and expenses, including expenses related to the execution of portfolio trades. In the United States, Section 28(e) of the Securities Exchange Act and related guidance from the U.S. Securities and Exchange Commission (“SEC”) govern the permissible uses of client commission payments. In adopting Section 28(e), the U.S. Congress recognized that properly managed client commission arrangements can and do benefit investors and the securities markets by providing

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<sup>1</sup> The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter.

investment managers with sophisticated and specialized research from a variety of sources to assist them in making investment decisions.<sup>2</sup> The SEC has consistently reinforced this view through its interpretations of Section 28(e).

Both Section 28(e) and the FSA's current approach to client commission arrangements permit the use of client commissions to pay for "execution" and "research" services. The Institute recently expressed its strong support for SEC proposals to narrow and more clearly define the types of services that constitute "execution" and "research" and may be obtained through client commission arrangements.<sup>3</sup> We have followed closely and support previous FSA efforts along the same lines.

### *Unbundled Disclosure*

We disagree with the FSA on its new requirement that investment managers—without any corresponding legal duty on brokers—provide to their clients estimates of the monetary value of the execution and proprietary research components of the brokerage commissions paid. This approach has two shortcomings. First, the FSA approach requires investment managers to assume liability for disclosing something that they cannot know, but can only estimate in good faith. When fund commissions are used to acquire both execution and research services, only the broker will know the commission it would charge for execution-only services.<sup>4</sup> To comply with the new rule, fund managers must either prevail upon brokers to provide the information, estimate the allocation of bundled commission payments between execution and research on their own, or perhaps do both when the information obtained from a broker does not seem reliable to the manager.<sup>5</sup>

In addition, because investment managers will have to estimate execution and research allocations, the FSA's approach will generate inconsistent disclosure. Without any legal obligation on brokers to provide an accurate and consistent breakdown of the research and execution components of commissions, investment managers will use different methodologies to allocate commission payments. Allocation methodologies could be based on the value of the research to the manager, the presumed cost of the research to the broker, the hypothetical price the broker would charge for the research, and/or comparable execution-only rates in other

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<sup>2</sup> Congress feared that "the future availability and quality of research and other services . . . could be jeopardized, with potentially harmful consequences to all investors" if managers were required to select brokers based only on the lowest available commission rate. *See* H.R. Rep. No. 123, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess. 248 (1975).

<sup>3</sup> *See* Letter from Paul Schott Stevens, President, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated Nov. 25, 2005 (File No. S7-09-05) (hereinafter "2005 ICI Letter").

<sup>4</sup> One of the FSA's primary assumptions seems to be that an execution-only price exists in every market and country with every broker. This is not the case, especially for many international markets where there are no execution-only benchmarks. For the many markets and many brokers that do not offer execution-only services, there simply is no available execution-only price.

<sup>5</sup> It appears that some brokers are not responding to managers' requests for information. *See* "Fund Managers Weigh Options for Splitting Commission Costs," *Compliance Reporter* (Nov. 14, 2005). In those cases, managers will have to rely on their own estimates of the execution and research components of bundled commission payments.

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venues. Even a single manager using a consistent methodology may generate different (and seemingly inconsistent) disclosure, because, for example, the “value” of the same research received from a particular broker may be greater for one type of investment strategy than another. The lack of comparability and reliability of the information disclosed significantly diminishes its utility and may lead to client and market confusion rather than the desired improvement in market efficiency and competition.

Our concern over the accuracy and reliability of unbundled disclosure reflects, in part, the unique features of mutual fund regulation in the United States. Here, unbundled disclosure would likely be required to be made in the fund prospectus, with corresponding liability risks. The disclosure would also be presented to fund boards, which would then be required to consider the disclosure as part of the annual decision to retain the investment adviser. In these contexts, the reliability and comparability of the disclosure is absolutely crucial.

In questions 1 and 2 of the consultation paper, the FSA generally seeks input on whether commission-related disclosure in the retail fund context should be made directly to retail investors or to an “investors’ representative.” As made clear by the preceding discussion, we agree with the FSA that unbundled disclosure to retail investors would detract from the key messages in fund disclosure documents that help investors make investment decisions. While we agree in principle that an investors’ representative is far more likely than retail investors to understand and be able to act upon detailed commission-related disclosure, we believe it is unlikely that unbundled commission disclosure provided even to an investors’ representative will be meaningful unless brokers have a legal obligation to provide accurate figures to the investment manager.<sup>6</sup>

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We appreciate the opportunity to express our views on this complex and important topic. We would also like to express our appreciation to the FSA representatives who met with Paul Stevens and Bob Grohowski of the Institute in December 2005 to discuss the topics addressed in this consultation.

If you have any questions about our comments or need any additional information, please contact me at +1 202 326-5815 or Bob Grohowski at +1 202 371-5430.

Sincerely,

/s/ Elizabeth Krentzman

Elizabeth Krentzman  
General Counsel

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<sup>6</sup> In this situation, investment managers would still be responsible for ensuring that the aggregate value of execution and research services received from a broker is reasonable in light of the commission paid, as required by COB 7.18.3 in the United Kingdom (or Section 28(e) of the Securities Exchange Act in the United States). But the investment manager would not have to assume sole liability for estimating and disclosing unbundled commission rates that it cannot know without mandatory input from the broker.

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### **About the Investment Company Institute**

The Investment Company Institute seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. The Institute's membership includes 8,537 open-end investment companies (mutual funds), 669 closed-end investment companies, 157 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the Institute have total assets of approximately \$8.672 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 89.5 million shareholders in more than 52.6 million households. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 187 associate members, which render investment management services exclusively to non-investment company clients. A substantial portion of the total assets managed by U.S.-registered investment advisers is managed by these Institute members and associate members.