



Client Briefing

Soft Commission and Bundled Brokerage: The 2006 UK Financial Services Authority ("FSA") Regime

July 2006

We set out below the general scope of the regime introduced by the FSA in its final rules contained in the July 2005 Policy Statement (PS05/9). This provides the policy background and detailed tests which must be applied in considering soft commission and bundled brokerage questions.

PS05/9 introduced into the FSA's Conduct of Business Sourcebook ("**COB**") a new section, 7.18, and deleted from COB2.2, formerly entitled "Inducements and Soft Commissions," rules 2.2.8R to 2.2.20R, which dealt with the requirements of, and allowable benefits under, soft commission agreements, as well as prior and periodic disclosure requirements, in relation to soft commission agreements. The title of COB2.2 now simply reads "Inducements." The new rules came into full effect on 1 July 2006.¹

General Principles

In paragraph 1.6 of PS05/9, the FSA summarises the effect of its rules, together with the introduction of "an enhanced industry disclosure regime to tackle the identified lack of transparency and accountability." The result will be to:

- *"Limit investment managers' use of dealing commissions to the purchase of execution and research services;*
- *Require investment managers to disclose to their customers details of how commission payments have been spent and what services have been acquired with them;*
- *Embed in the commercial relationship between investment managers and brokers incentives to secure value for clients for execution and research spend; and*
- *Promote competition between those who produce investment research by removing the regulatory distinction between research services provided by brokers along with execution (i.e., bundled services) and research services provided by third parties (i.e., softed services)."*

Application of Regime to Investment Managers

The rules in COB7.18 apply to investment managers which execute customer orders (7.18.1(1)R) and not directly to brokers. In addition their scope is limited to the following investments:

- (a) shares; and
- (b) (i) warrants;
- (ii) certificates representing certain securities;
- (iii) options; and
- (iv) rights to or interests in investments of the nature referred to in (i) to (iii) in each case to the extent that they relate to shares (7.18.1(2)R). The rules do not therefore apply to investment managers executing customer orders for futures, options other than those above, or contracts for differences.

¹ Their effective date was 1 January 2006 subject to a transitional period which ended on 30 June 2006.

COB7.18 also requires prior and periodic disclosures to which the investment manager is subject.

FSA Principles on Soft Commissions

To the extent that COB7.18 is not directly applicable because the entity involved is, e.g., a broker and not an investment manager, COB2.2.3 “Prohibition of Inducements” and/or certain of the FSA’s Eleven “Principles for Business” must be considered. Principle 1 (Integrity) requires a firm to conduct its business with integrity. Principle 6 (Customers' Interests) requires a firm to pay due regard to the interests of its customers and treat them fairly. Principle 8 (Conflicts of Interest) requires a firm to manage conflicts of interest fairly, both between itself and its customers and between one customer and another (see COB7.18.2.)

COB2.2.3 Prohibition of Inducements provides as follows:

“A firm must take reasonable steps to ensure that it, and any person acting on its behalf, does not:

- (1) offer, give, solicit or accept an inducement; or*
- (2) direct or refer any actual or potential item of designated investment business to another person on its own initiative or on the instructions of an associate;*

if it is likely to conflict to a material extent with any duty that the firm owes to its customers in connection with designated investment business or any duty which such a recipient firm owes to its customers.”

COB7.18.15 provides that:

“COB 2.2.3 R (prohibition of inducements) does not apply to an investment manager that complies with the requirements of [COB7.18] in receiving goods or services in accordance with COB 7.18.3 R (Use of dealing commission to purchase goods or services).”

The COB 7.18.3R requirement applies where an investment manager executes customer orders through a broker and passes on the broker's charges (whether commission or otherwise) to its customers; and in return for those charges receives goods or services in addition to the execution of its customer orders (COB7.18.3(2)R) and permits such arrangements only where the investment manager:

“has reasonable grounds to be satisfied that the goods or services . . . (i) are related to the execution of trades on behalf of the investment manager's customers; or (ii) comprise the provision of research; and (b) will reasonably assist the investment manager in the provision of its services to its customers on whose behalf the orders are being executed and do not, and are not likely to, impair compliance with the duty of the investment manager to act in the best interests of its customers.”

COB7.18.4(1)E and 7.18.5(1)E explain the circumstances in which an investment manager will have such reasonable grounds to be satisfied in relation respectively to execution and research. The execution requirement will be met (COB7.18.4(1)E) *“if the goods or services are: (a) linked to the arranging and conclusion of a specific investment transaction (or series of related transactions); and (b) provided between the point at which the investment manager makes an investment or trading decision and the point at which the investment transaction (or series of related transactions) is concluded.”*

In relation to research, the requirement will be met if the research (COB7.18.5(1)E):

“(a) is capable of adding value to the investment or trading decisions by providing new insights that inform the investment manager when making such decisions about its customers' portfolios; (b) whatever form its output takes, represents original thought, in the critical and careful consideration and assessment of new and existing facts, and does not merely repeat or repackage what has been presented before; (c) has intellectual rigour and does not merely state what is commonplace or self-evident; and (d) involves analysis or manipulation of data to reach meaningful conclusions.”

The next stage in the analysis is to note the examples set out in COB7.18.6E – COB7.18.8E of goods and services which the FSA states will not meet the above requirements and which, therefore, a manager cannot purchase with commission. These are:

- post-trade analytics (in relation to execution of trades) (COB 7.18.6G);
- price feeds and historical price data that have not been analysed or manipulated to reach meaningful conclusions (in relation to provision of research) (COB 7.18.7G);
- and each of the following (in relation to execution of trades provision of research) (COB 7.18.8G):
 - (a) services relating to the valuation or performance measurement of portfolios;
 - (b) computer hardware;
 - (c) dedicated telephone lines;
 - (d) seminar fees;
 - (e) subscriptions for publications;
 - (f) travel, accommodation or entertainment costs;
 - (g) office administrative computer software, such as word processing or accounting programmes;
 - (h) membership fees to professional associations;
 - (i) purchase or rental of standard office equipment or ancillary facilities;
 - (j) employees' salaries;
 - (k) direct money payments;
 - (l) publicly available information; and
 - (m) custody services relating to designated investments belonging to, or managed for, customers other than those services that are incidental to the execution of trades.

Gifts and Entertaining

The rules on the provision of gifts and entertaining are derived from COB2.2.3 and the FSA's Principles. In order to determine whether such activity is permitted in any individual situation, an assessment of whether the gift or entertainment is reasonable and proportionate in the context of the relevant business relationship must be made, together with a determination that there is no issue of a conflict with the duties owed by the recipient to its customers.

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03/07/2007