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FRAMEWORK FOR BROKER COMPENSATION BY INVESTMENT MANAGERS

The French Association of Investment Firms (Association Française des Entreprises d'Investissement, AFEI) and the French Asset Management Association (Association Française de la Gestion Financière, AFG) began a joint analysis in late 2005 of the way in which investment managers compensate brokers for their services.

At a time when the situation in France and internationally demands a clearer framework for relations between these two constituencies, this analysis has five main goals:

- Seek consistency with the mechanism recently implemented in the UK, since the vast majority of investment management companies and brokers operating in France have significant ties to their British counterparts.
- Specify the type of services – i.e. order execution, and investment/trading decision support – that can be compensated by commissions paid when an investment manager initiates a transaction on behalf of a client.
- Establish a formal process to produce a consensus among brokers and investment managers on the types of services offered and the value that they add, it being understood that this value is often underappreciated in France.
- Spell out the conditions in which investment managers can enter into a commission sharing arrangement, whereby they ask the brokers that execute their orders to rebate to a third party some or all of the compensation paid for investment/trading decision support.
- Adopt a flexible, open-ended mechanism that companies can easily adapt to their size and their business lines.

After completing their analysis, AFEI and AFG decided to draw up a joint Charter of Good Practice organised around eleven high-level principles that govern the framework for broker compensation by investment managers. A User's Guide explains the background to the charter and offers practical advice on implementing its underlying principles.

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FRAMEWORK FOR BROKER COMPENSATION BY INVESTMENT MANAGERS

AFEI-AFG Charter of Good Practice

Introduction

This Charter of Good Practice establishes the framework in which investment managers compensate brokers for their services. It is the result of a joint effort by the French Association of Investment Firms (Association Française des Entreprises d'Investissement, AFEI) and the French Asset Management Association (Association Française de la Gestion Financière, AFG). The French Society of Investment Analysts (Société Française d'Analyse Financière, SFAF) was also involved.

There is a need for better understanding of broker services and their value to investment managers, especially since commission sharing arrangements are now being advocated (see, inter alia, Recommendation 5 of the report issued in July 2005 by the French securities regulator, the Autorité des Marchés Financiers, *"A fresh start for independent financial research in the French market"*). In this context, the AFEI-AFG Charter of Good Practice is intended to supply a framework for financial market participants. This framework is deliberately flexible so that firms can adapt it to their size and business lines. It is based on eleven principles, listed below. Investment managers and brokers should use the charter whenever the commissions paid by a manager exceed a sufficiently material threshold.

To help firms implement these principles, AFEI and AFG have also prepared a User's Guide that explains the background to the charter and clarifies the meaning and scope of each principle. The guide also gives examples that brokers and investment managers can use to design their own internal procedures.

AFEI and AFG have agreed to revisit the charter and the User's Guide annually to make any changes deemed necessary in light of new circumstances.

Principle 1

The commission paid to a broker for a transaction initiated by an investment manager acting on behalf of its clients is compensation for the services of order execution and investment/trading decision support.

Principle 2

In a regular, organised service relationship, and where the total commission paid for the execution of trades initiated by an investment manager exceeds a sufficiently material threshold, the split between the compensation paid for order execution services and that paid for investment/trading decision support services is determined through a broker review conducted jointly by the investment manager and the broker.

Principle 3

The broker review covers all aspects of the service relationship between the investment manager and the broker.

The broker review pertains to the services provided during a prior reference period agreed upon by the investment manager and the broker. Whatever the circumstances, the review should include at least one meeting per year between the two parties.

Principle 4

When an investment manager and broker establish a relationship, they may carry out a forward-looking broker review.

Principle 5

The results of the broker review, inter alia, serve as a basis for establishing the nature of the services the broker will supply to the investment manager over the subsequent reference period, or any other agreed period, and the terms of compensation.

Both parties must keep a record of the review's conclusions.

Principle 6

The investment manager and the broker have the right to amend by joint agreement, before the end of the reference period, the organisational arrangements made in compliance with Principle 5.

Principle 7

The investment manager can ask the broker, on condition that the broker provides at least order execution services, to rebate some or all of the commission paid on a trade to one or more third parties of its choice for the purpose of compensating investment/trading decision support services.

The terms of this third-party rebate by the broker must be formally established in a commission sharing agreement.

This compensation framework excludes a range of services, specified in a list.

Principle 8

A commission sharing agreement may not be implemented without a broker review.

Principle 9

A commission sharing agreement may be re-examined during each broker review or at any other time agreed by the investment manager and the financial intermediary; if need be, it may be amended.

Principle 10

A commission sharing agreement is intended to replace the system of soft commissions between the investment manager and the broker.

Principle 11

The investment manager and the broker establish a reporting procedure to ensure that the manager is informed about the performance of the arrangements set out in the broker review and in the commission sharing agreement, if any.

These reports must be supplied at least once a year according to a schedule agreed by the investment manager and the broker.

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FRAMEWORK FOR BROKER COMPENSATION BY INVESTMENT MANAGERS

User's Guide to the AFEI-AFG Charter of Good Practice

1. In light of Recommendation 5 of "*A fresh start for independent financial research in the French market*", published by an AMF working group in July 2005, and of developments under way internationally, the French Association of Investment Firms (Association Française des Entreprises d'Investissement, AFEI) and the French Asset Management Association (Association Française de la Gestion Financière, AFG) decided in November 2005 to form a joint working group. The purpose of the group, which also included the French Society of Investment Analysts (Société Française d'Analyse Financière, SFAF), was to establish a standard framework to govern broker compensation by investment managers.

The group (see Schedule 1), which met almost every week until the end of January 2006, concluded that AFEI and AFG should draw up a Charter of Good Practice based on eleven high-level principles to form a framework for broker compensation by investment managers. Developed in close partnership with the French securities regulator (AMF), the AFEI-AFG Charter was approved by the Boards of AFEI and AFG and published in July 2006.

2. The working group's discussions highlighted the complexity of the subject matter and the importance of understanding all the various facets. It was therefore decided that the AFEI-AFG Charter should contain an explanatory section. This requirement became especially important when the working group decided to base the Charter on a limited number of high-level principles, which needed to be assessed within a common frame of reference.

That is the goal of this User's Guide, namely to clarify the background to the Charter, to help explain the content and scope of each principle, and to give examples that brokers and investment managers can use to design their own internal procedures.

3. The User's Guide is divided into three sections. The first describes the background to the AFEI-AFG Charter and defines the project's goals; the second explains the content and scope of the principles set forth in the Charter; and the third contains a set of schedules providing further details and, in some cases, examples.

Like the Charter, the User's Guide will be re-examined annually, and AFEI and AFG will make any changes deemed necessary in the light of new circumstances.

A. – BACKGROUND TO THE AFEI-AFG CHARTER

- ***The framework governing relations between investment managers and brokers needs to be clarified in view of the domestic and international environment***

4. AFEI and AFG have published their charter at a time when French and international markets are undergoing major developments and when closer attention is being paid to the nature of and conditions of payment for the services that brokers provide to investment managers. These developments can be broken down into three trends, summarised as follows:

- better understanding of the services provided to investment managers
- stricter definitions of the services that may be compensated with the commissions paid to brokers when orders are executed
- introduction of mechanisms whereby an investment manager can ask a broker to rebate some or all of such commission to third parties in respect of services they provide ("softing")

5. At least three countries have recently taken an interest in these questions, adopting different approaches depending on their laws and market conditions.

- **Report of the AMF working group on independent financial research**

  An AMF working group headed by Jean de Demandolx Dedons issued a report in July 2005 entitled “*A fresh start for independent financial research in the French market*”. The report made proposals for promoting independent research in future and ensuring the long-term viability of the system for financing it. In particular, Recommendation 5 called for regulatory approval for the unbundling of brokerage commissions, so that dealing commissions and investment research services would be billed separately and the research-related component could be passed on to an independent research company.

  The report stressed that, as with the system recently adopted in the UK, brokerage commissions could be broken down and invoiced in two parts:
  - "execution, which includes trading, back office services, commercial follow-up and monitoring the market status of securities; and
  - research"

  This analytical breakdown is the first basic step towards enabling investment managers to gauge the value of the resources allocated to sell-side research. Unbundling the various services will make it possible to put a price or “market” value on research. The portion of the commission paid by the investor and received by the broker can thus be rebated, in the proportions established by the investment manager, to the independent research house of the manager's choice. This transfer of resources will eventually provide funding for large, independent research firms that are viable over the long term, thus fostering a new type of fundamental research.

On this issue, see also 10 *et seq.*

- **Developments in the UK**

In July 2005, the Financial Services Authority (FSA) published Policy Statement 05/9, which requires investment managers operating in the UK to provide their customers with a breakdown of commissions paid to brokers, stipulating the split between order execution and other services, including research. The rules, which took effect 1 January 2006 with a transitional period until 30 June 2006, replace previous regulations on soft commissions.

This prompted the professional associations in the forefront of these issues [1] to examine how investment managers could make brokers comply with the new transparency requirements. With the FSA's encouragement, the associations prepared codes of good practice[2] laying down the conditions for ensuring compliance with the requirements and the transmission of information between the various parties.

For a more detailed presentation of developments in the UK, see Schedule 2.

- **Ongoing developments in the USA**

In light of these changes in UK regulations, the US Securities and Exchange Commission (SEC) published "*Commission guidance regarding client commission practices under Section 28 of the Securities Exchange Act of 1934*" in November 2005. The aim of these guidelines is to clarify the definitions of execution and research services that account managers can use under Section 28 of the Securities Exchange Act. Section 28 establishes a safe harbour that allows money managers to use client funds to purchase brokerage and research services without breaching their fiduciary duties to their clients.

It is also worth noting that Fidelity Investments, a US fund manager, decided in October 2005 to use its brokers for execution only and to pay for research services with corporate assets. However, the working group emphasised that this type of decision is unlikely to become commonplace, since only a few market participants – ones as large as Fidelity – have the wherewithal to make such a move, in particular by opening their own research departments.

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[1] The London Investment Banking Association (LIBA), which represents London-based investment banks; the Association of Private Client Investment Managers and Stock Brokers (APCIMS), which represents UK brokers; and the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF).

[2] See *Statement of good practice* (LIBA, March 2005); *Pension fund disclosure code* (IMA, March 2005); and *Unbundling and soft commissions disclosure arrangements for APCIMS' members* (APCIMS, November 2005).

➢ **Part of the regulatory base already exists**

6. Article 322-36 of the AMF General Regulation stipulates that investment managers must select brokers independently in the interests of investors or clients, while Article 322-50 requires that investment managers adopt a formal, auditable process incorporating objective criteria, such as execution or research, when selecting and evaluating their brokers.

7. This explains why, aside from existing or forthcoming regulatory requirements, investment managers are already paying more attention to the outside services that they use and pay for. Consequently, while some regulators have been focusing closely on this issue in recent months, that attention has simply accelerated an existing trend and put it on a formal basis.

➢ ***Developments in the UK inevitably influence the French approach***

8. The French financial markets do not exist in a vacuum, with French brokers supplying services solely to French investment managers, or with managers purchasing services solely from domestic brokers. Managers and brokers both rely on foreign firms for a significant portion of their revenues. And they are particularly reliant on UK firms, given the predominant role played by the City at the European and worldwide levels.

While obvious, this observation is worth stressing because it has a direct consequence, namely that the French framework for transparency and compensation in investment services cannot be based on principles that differ fundamentally from those used in the UK. Likewise, for French regulations to have long-term credibility, they cannot diverge from British regulations, which are used by market participants with substantial economic clout in Europe. It is also impossible to expect French brokers and managers to use two sets of standards simultaneously, i.e. French for domestic business and British for international activities.

9. The FSA's regulations and the professional framework set out in the codes of good practice drawn up by associations of UK brokers and investment managers (see §5) form a body of standards that strongly influenced the approach of the AFEI-AGF working group. The desire – or rather, the need – for consistency does not mean that the AFEI-AGF Charter simply copies the UK standards. But the group did continually strive for consistency, agreeing that its solutions would not diverge from those in the UK except where absolutely necessary in view of specific conditions in France.

This is why the AFEI-AGF Charter is in many ways similar to the codes of good practice produced by the British professional associations.

- ***The Charter can be an indirect response to the need for independent research***

10. As already mentioned, one of the factors that prompted the AFEI-AFG Charter was a report on independent financial research, produced by the AMF working group headed by Jean de Demandolx Dedons (see §5). However, the AFEI-AFG working group's goal was clearly not to propose direct solutions to the issue raised by the report's title, since this would involve the emergence of independent, specialised research outfits with no brokerage business.

Moreover, as emphasised by the AMF report, the development of independent research is a much broader issue involving complex questions of corporate business models, and the working group' remit did not extend to resolving such issues.

11. Hence, of the eight recommendations in the AMF report, the AFEI-AFG Charter addresses Recommendation 5 only, and, even then, in an ancillary manner (see §26 *et seq.*). Yet this recommendation is crucial to achieving the report's aim, since it is through commission sharing arrangements, which the Charter recognises and formalises, that some of the dealing commissions paid to brokers can be rebated to research firms with no ties to a broker. This will free up resources to finance research analysts who are not affiliated to brokerages.

However, the purpose of the AFEI-AFG Charter is not solely to cultivate the capacity for funding independent financial research. Another equally valid possibility would be, for example, to enable an investment manager to purchase execution-only services from one broker and research only from another broker. And in any case, this compensation mechanism could be used for many more types of services than just investment research (see §27 *et seq.*).

- ***Putting an explicit value on the services provided to investment managers is a key issue for our markets***

12. When users pay for a service, they are paying for the value that the service provider brings them. So it is essential to determine the exact value of each service.

Accordingly, the working group considered that one of its key tasks was to ensure a clear understanding of the value of the services purchased with dealing commissions. This led to the conclusion that the existing process in France was inadequate.

13. In a context where dealing commissions also pay for investment/trading decision support services, the working group observed that:

- Execution services are too often viewed as a basic commodity with no added value. This negative perception has been encouraged in recent years by the development of direct market access (DMA) services. Widespread use of order routing screens gives investment managers access at low (or very low) cost to real-time market data that is as good as the information available to brokers. This has fostered the impression that there is little value added to order execution. French clients in particular, much more than foreign clients, are constantly pressuring brokers to lower the cost of execution.

- The value of investment/trading decision support services, particularly research and analysis services, is underappreciated[3]. From this standpoint, the sell-side research model, which has predominated in recent years, has undoubtedly contributed to the lack of appreciation: by emphasising execution services over financial research, the model helped create the impression that customers were paying for execution services alone and that research was an entitlement, provided free of charge along with execution. As a result, investment/trading decision support services suffered from the same downward price pressure as execution services.

14. As the working group's discussions have shown, this widespread underappreciation of both execution services and investment/trading decision support services, which is particularly prevalent in France compared with other securities markets, does not reflect the real situation.

First, with respect to investment/trading decision support services, the tools now being developed by some investment managers to assess order execution show that quality is key to investment returns. There is no comparison between the value of well timed execution with minimal market impact and the handful of basis points that investment managers and brokers sometimes quibble over.

Second, with respect to investment/trading decision support in general, and research in particular, it is also clear that the quality of these services has a direct influence on investment returns. Making the right investment decision at the right time is crucial for any investment manager. This is why the quality of investment/trading decision support services is now the main factor in broker selection and rankings.

[3] In some cases, research services are deemed to destroy value. A good example of this is the belief that investment analysts in general, and sell-side analysts in particular, played a major role in inflating the internet bubble of the early 2000s. In the public's mind, analysts are often identified as the main – sometimes the only – cause of the bubble. This attitude overlooks the fact that widespread "irrational exuberance", which is characteristic of bubbles, also played a role.

15. This disconnect between the value added by execution and investment/trading decision support services and the amount paid for them is a source a considerable concern, particularly since intense international competition is fierce and the quality of these services hinges largely on the quality of the professionals who provide them.

In an industry where "the production tool goes home every night", firms' ability to provide high quality market services – whether execution or investment/trading decision support, and whether or not the firms are brokers in the strict sense of the term – is closely linked to their ability to attract and keep the most talented professionals in the business.

16. Under present circumstances, there is no way that French firms can hold onto staff if their services do not command the same compensation as they would abroad. If they earn less with services of comparable quality, firms will be less able to compensate their employees. And those employees may be tempted to market their talents to foreign firms that recognise their quality and will pay them in line with international standards. London is attractive to French workers for a number of reasons, not least of which is the capacity of City firms to pay for market expertise.

More generally, given that a substantial proportion of execution and investment/trading decision support services is now supplied by international companies with a large foreign clientele, firms must decide where to allocate their resources. If French clients are unwilling to pay a fair price for the services they use, then firms will reassign their internal resources to serve clients who are willing to pay. This trend, which the working group considers unavoidable, will accelerate as firms realise the true costs of different types of services in light of developments in the UK.

17. The question of paying a fair price for the services provided to investment managers should thus be seen from the perspective of the Paris marketplace as a whole. Aside from the direct consequences in terms of a brain drain and lower value-added in the marketplace's services, the overall quality and intensity of the services provided to French investment managers by Paris-based firms is at stake.

In the situation described here, there is a real risk that services will lose their substance, and it is hard to see who would benefit from this. Assuming that the quality of execution and investment/trading decision support services is a vital factor that helps investment managers create value for their clients, the outcome is inevitable. Once Paris's existing capacities have been destroyed[4], investment managers will be forced to purchase services from firms outside France – unless they believe they can underperform their foreign competitors over the long term. At that point, not only will the services be priced according to the international benchmark, but since their providers will not be based locally, they may not respond entirely to managers' needs.

[4] Service providers may remain, but quality will be inferior because the best professionals will have migrated to foreign markets where their services will be more fairly compensated.

In addition, this situation is bound to have an effect on issuers.

18. The working group concluded that, unless awareness is raised and the current trend reversed, the substantial, unrelenting pressure to lower dealing commissions designed to compensate investment/trading decision support services will inevitably take its toll on the services available to French market participants.

➤ *The broker review is key to fostering a shared understanding of service value*

19. Since it is absolutely necessary that participants have an accurate perception of the value added by various services, the broker review plays a central role in the AFEI-AGF Charter. The broker review is a process during which the investment manager and broker agree on the broker's compensation or on the weighting assigned to each of the services. Based on this evaluation, the investment manager and the broker both assess the economic value of the various services[5].

In practical terms, the broker review assumes firstly that the investment manager has an idea of the value contributed by each service. These values are often determined by internal voting mechanisms, which can be relatively complex. At this point, commercial negotiations with the broker can begin, and the two parties will compare their estimated values for each service. In the end, both will reach an agreement on the types of services to be provided and how they will be paid for[6].

20. As described here, the broker review is clearly not an invention of the working group. It is a well established practice, stemming directly from firms' existing regulatory requirement to "*implement a formal, auditable procedure for selecting and evaluating intermediaries and their counterparties, taking into account objective criteria such as cost of intermediation and quality of execution, research and transaction processing*" (*AMF GR, Article 322-50*).

But in France, as the working group noted, the broker review is inadequate because too often it does not enable the broker to understand and analyse why the value estimated by the investment manager is so different from its own estimates. Accordingly, there is a pressing need to establish a formal framework for broker reviews so that investment managers and brokers can really communicate their perceptions of the value created by each service. The AFEI-AFG Charter is designed primarily to facilitate this dialogue.

[5] The investment manager may consider that the cost of the service outweighs its usefulness. The broker may decide no longer to offer certain services if it concludes that they are inadequately compensated.

[6] Note that this agreement is meant to cover the entire reference period; it is not renegotiated with each transaction.

21. Because the broker review imposes an organisational constraint on the investment manager and the broker alike, the working group decided that it was warranted only if the service relationship was sufficiently material. However, the Charter does not define a threshold beyond which this condition is met and a broker review must therefore be carried out. The working group decided that too many factors entered into the equation to allow for a general rule. The Charter therefore calls for a broker review "*where the total commission paid by an investment manager for trade execution exceeds a sufficiently material threshold*" (***Principle 2***).

However, to give investment managers and brokers a better understanding of exactly which situations are at issue, the working group considers that:

- the threshold is material when the total commission paid annually by an investment manager exceeds €1 million; and
- in this case, the investment manager should conduct broker reviews with at least the five brokers to which it pays the most commission.

The working group agreed that these quantitative criteria should be specifically re-examined as part of an annual review: AFEI and AFG will check whether these amounts are still relevant in light of the real-world experience gained in the early months of the Charter's implementation.

22. The group was anxious not to impose an organisational constraint that was out of proportion to its goals. Naturally, the frequency and intensity of a broker review, if any, should be commensurate with the importance and diversity of the service relationship between the investment manager and the broker. Accordingly, while an annual review will be sufficient in many situations, the value of the broker's services may be reassessed twice yearly or even quarterly if the relationship is more important. Similarly, while an overall review can be conducted for relationships involving occasional services or services with marginal value relative to a firm's overall business, when it comes to more important relationships, it may be appropriate to distinguish services on the basis of different goals or fund management styles or, alternatively, according to the markets on which the services are provided.

Whatever the circumstances, however, the broker review must ultimately lead to an agreement on the terms of compensation for each service.

➢ *Commission sharing is a suitable response that maintains bundled compensation while diversifying the pool of service providers*

23. In practice, as noted in the AFEI-AFG Charter (***Principle 1***), the dealing commissions paid by investment managers to brokers compensate a full range of services that fall into two main categories, execution services in the strict sense and investment/trading decision support services (see §27 *et seq.*).

While broker reviews make it possible to place a value on each service separately, the services are not paid for individually. That would require each service to be invoiced separately. Separate invoicing is not currently possible in a mechanism based on trade confirmations, where the "execution" and the "investment/trading decision support" components are indistinguishable from an operational and technical standpoint. The flow of investment/trading decision support services is not correlated in the short term with the flow of executions. Investment/trading decision support services are produced at irregular intervals, from daily flashnotes to annual research reports, and they vary in terms of content and format (see Schedule 4). By contrast, transactions are carried out on a regular basis.

Moreover, it is the goal of the broker review to match the two flows over the medium term. During the reference period established by contract between the broker and the investment manager, compensation payments tied to execution services are consolidated in order to balance them, in non-accounting terms, with compensation payments tied to investment/trading decision support services.

24. Investment managers their dealing commissions to compensate an entire range of services provided by brokers. The concept of managers selecting exactly which services they wish to receive – and pay for – has not really been raised until now. Accordingly, it is still standard practice for investment managers wishing to do business with a broker to guarantee a minimum volume of executions, and thus dealing commissions, which give the manager access to the broker's full range of services, as opposed to only those in which it is specifically interested.

This technique of "bundled services", which actually met a real need among investment managers for many years, is now being called into question in the wake of developments in the UK. Investment managers increasingly want as much flexibility as possible to select the best services from each provider. They also want, whenever possible, to be able to purchase services from firms not affiliated with brokers.

25. Commission sharing, envisaged for reasons stated above in the report by the AMF working group headed by Jean de Demandolx Dedons (see §5, 10 and 11) and implemented through the AFEI-AFG Charter, is a suitable response to the two-fold goal of maintaining bundled compensation while diversifying the pool of service providers.

Commission sharing is the contractual mechanism by which an investment manager arranges with a broker for a pre-defined share of the compensation paid in the form of dealing commissions to be rebated at the manager's request to a third party providing services that "complement" execution (see §27 *et seq.*). Hence, investment managers can continue paying a single commission for execution services while diversifying their access to other service providers.

➢ *Commission sharing, an outcome of the broker review*

26. That a portion of dealing commission can be rebated to a third party is definitely linked to the existence of the broker review, which enables both parties to determine, ahead of time, precisely which services are covered by these payments, as well as the value of each service. Only the transparency provided by the broker review enables the investment manager and broker to agree on the conditions in which the broker may rebate part of its commission to a third party.

This is why, in addition to a formal broker review, the AFEI-AFG Charter includes an option enabling firms to implement a commission sharing arrangement (***Principle 7***). In this case, however, the arrangement is merely an indirect consequence of the broker review. A commission sharing agreement cannot be implemented without a broker review (***Principle 8***), but just because a broker review is conducted does not mean the parties must adopt such an agreement. An investment manager may decide that the services provided by its broker are properly valued and fairly compensated and that there is no need to transfer part of the compensation to a third party in respect of complementary services. In fact, the working group feels that such situations are likely to be fairly common.

➢ *Service classification is an important part of these deliberations*

27. The working group discussed the types of services that might be eligible for a rebate to third parties under a commission sharing arrangement. It concluded that the dealing commission mechanism made it possible to compensate two main categories of service: execution and investment/trading decision support.

Execution services can generally be defined as the human and technical resources made available to an investment manager so that it can invest or divest under optimal conditions, regardless of whether it uses investment/trading decision support services beforehand. This encompasses:

- the supply of explanatory or forward-looking information about market movements
- order execution, in any form (DMA, algorithm, discretionary, natural crossing, etc.)
- follow-up services, e.g. order confirmation, reporting, settlement

Investment/trade decision support services can generally be defined as the human and technical resources made available to an investment manager in order to add value to its investment or divestment decisions. This encompasses:

- research
- financial analysis
- advice and sales services
- access to companies and their management
- trade analysis
- the supply of market information, depending on the situation

28. Based on this breakdown of the two main categories, and for the sake of consistency with the UK, the working group has decided that only compensation in respect of investment/trade decision support services – i.e. not execution services – may be rebated to a third party. It is the view of the working group that the payment made to the broker responsible for rebating part of the compensation received as dealing commission would not be totally warranted unless it includes compensation for execution services at least.

This is why the AFEI-AFG Charter stipulates that a commission sharing agreement can be concluded only with a broker that provides at least order execution services, so that it can "*rebate some or all of the commission paid on a trade to one or more third parties [chosen by the investment manager] for the purpose of compensating investment/trading decision support*" (***Principle 7***).

29. Choosing a commission sharing arrangement that concerns only investment/trade decision support services naturally raises the sensitive issue of classification. The possibility of rebating a portion of dealing commission to a third party assumes that the complementary service paid for in this way falls under the heading of investment/trade decision support services.

From this standpoint, apart from the indications already given (see §27), it should be pointed out that the AFEI-AFG Charter does not provide a classification that distinguishes execution from investment/trade decision support – or from any other services for that matter. The manner of defining other services, i.e. those considered neither as execution nor as investment/trade decision support, is a key question, because these services will not be paid for with dealing commissions and cannot be covered by commission sharing arrangements.

30. Observing that discussions on this issue have been going on for more than two years in the UK, the working group felt that it should approach the topic with considerable caution, especially since this sort of classification comes mainly under the jurisdiction of the regulator. The group therefore decided to provide a classification only indirectly via the lists of examples presented in Schedules 3, 4 and 5 of the User's Guide.

This issue can seriously distort the level playing field at European level. For that reason, and since the SEC is also taking up the issue (see §5), the working group recommends that the Committee of European Securities Regulators (CESR) should lead an effort to harmonise service classifications at European level, with the involvement of the US authorities.

31. However, pending full harmonisation, the working group is submitting a list of services that clearly come under the heading of non-permitted services (***Principle 7***):

- services relating to the valuation of portfolios,
- purchase, lease or rental of computer hardware,
- dedicated telephone lines,
- seminar fees,
- subscriptions for publications,
- travel, accommodation or entertainment costs,
- office administrative computer software, such as word processing or accounting programmes,
- membership fees to professional associations,
- purchase or rental of offices,
- employees' salaries,
- direct money payments,
- custody services for securities.

Commission sharing and soft commissions

32. Article 322-44 of the AMF General Regulation stipulates how investment managers may receive soft commissions from brokers or their counterparties.

Basically, in a soft commission arrangement, a broker assumes the financial burden of supplying the investment manager with certain services, especially access to electronic market data. This practice, which resembles a commission rebate (except that it does not involve money but an outside service not paid for directly by the investment manager), is conditional on the investment manager providing a flow of orders to the broker. "Softing" became extremely popular in the 1990s but has declined significantly in recent years.

AMF GR, Article 322-44

Soft commissions may be received from the intermediaries or counterparties of the portfolio management company, provided that:

1° Such commissions do not contravene the best-execution obligation or the obligation to ensure competition among intermediaries.
2° Such commissions are of direct interest for clients or holders.
3° Such commissions are not paid in cash, nor by assuming the cost of goods or services corresponding to essential resources of the management company, such as administrative or accounting management, staff compensation, or offices.
4° Such commissions are covered by a written agreement that has been disclosed to the persons within the management company who are responsible for internal control and compliance.
5° The value of such commissions has been assessed by the management company and is specified in its annual financial statements.

Where the total value of soft commissions received by the management company on its portfolio management activity exceeds 1 per cent of its annual revenue, the implementing arrangements for these commissions are described in the company's management report. In particular, the report shall indicate the nature of the commissions, the agreements that govern them, the way they are valued, the way they are used, and the measures taken to prevent or deal with conflicts of interest in the choice of intermediaries.

33. This being the case, the working group considers that a commission sharing arrangement implemented by an investment manager will take the place of soft commissions, as in the UK. There seems to be no practical interest in maintaining the two systems simultaneously since one (commission sharing) is broader in scope and encompasses the other. Hence the AFEI-AFG Charter provides that commission sharing agreements will replace the system of soft commissions (***Principe 10***).

However, the working group did not believe that its remit extended to setting a deadline for replacement. It considered that this was the responsibility of the AMF, which should establish a transitional period during which the two systems could co-exist, so that investment managers and brokers with soft commission arrangements in place would have enough time to convert them into commission sharing agreements. Note that, in the same situation, the FSA decided on a transitional period of six months and announced the dates (1 January 2006 to 1 July 2006) six months before the period was scheduled to start. The working group recommends a transitional period of 18 months.

➢ *Third parties entitled to participate in commission sharing arrangements*

34. The working group considered the types of third parties that should be entitled to participate in commission sharing arrangements. More specifically, it weighed up the advantages and disadvantages of establishing such boundaries. Given the aim of encouraging a diverse pool of service providers (see §24 *et seq.*), it is clear that participation should not be limited to regulated entities, i.e. brokers (investment services providers). The investment/trading decision support services in question may be supplied by companies with no specific regulated status, such as specialised financial research houses or data vendors.

The working group does not therefore specify which companies may participate in commission sharing arrangements. That being said, investment managers must be able to explain the reasons for their choices at all times.

35. The working group addressed the specific issue of whether a share of dealing commission could be rebated to an entity belonging to the same corporate group as the investment manager. This type of situation could be seen to encourage mispractice. For example, an investment manager could ring-fence its research function in a specialised entity, which could thus benefit from a commission sharing arrangement, even though buy-side research cannot be purchased with dealing commissions at present.

That said, the working group still believes that the increased transparency provided by the broker review will help foster good practice and avoid such mispractice. In particular, the internal governance bodies of collective investment schemes (boards of directors, statutory auditors, etc.) will have more information with which to assess the quality of the services purchased by investment managers. The broker review is thus an appropriate tool for proactive, *ex post* management of potential conflicts of interest, especially since it is conducted regularly.

However, the special case of investment managers' direct subsidiaries that could potentially benefit from commission sharing arrangements must clearly be examined in detail relative to the existing regulations.

- ***Discussions have so far been confined to equity securities***

36. While not explicitly stated, the AFEI-AFG Charter applies only to service relationships involving equity or equity-equivalent securities. Although the debate will have to be extended and adapted to include other financial instruments such as fixed-income securities or derivatives, it was not within the working group's remit to address issues relating to those asset classes.

In any case, the French Banking Federation will have to be involved in any such extension.

- ***The AFEI-AFG Charter does not address the question of investment managers' transparency vis-à-vis their clients***

37. The question of brokers' transparency vis-à-vis investment managers naturally raises the corresponding question of investment managers' transparency vis-à-vis their clients. Moreover, in contrast to the French approach, this was the point of departure for the deep-seated changes that have taken place in the UK (*Schedule 2*).

However, the working group did not have a mandate to deal with this important question which, as emphasised above, is now a focal point of attention for many investment managers. The reason that the group did not address the question is simple: it concerns only investment managers and not brokers, and so is not an appropriate question for AFEI and AFG members to address jointly. It is exclusively the domain of AFG, which intends to look into the matter.

➢ *The AFEI-AFG Charter and the regulatory framework*

38. The AFEI-AFG Charter has been designed as an autonomous mechanism and a component of a self-regulatory technique to provide investment managers and brokers with a standardised, common tool that could be adapted as market practices and technologies evolve and that would facilitate the operational management of commercial relationships in a multilateral framework.

However, as demonstrated by Recommendation 5 of the Demandolx Dedons report, it appears that the AMF General Regulation will have to be amended so that commission sharing can be implemented in France. Evidently, the current regulatory framework, and especially Articles 322-41 and 322-44, does not permit commission sharing agreements. Moreover, the AMF's own initial analysis points in this direction.

Hence, the working group has drafted proposed amendments and submitted them to the AMF with a view to providing a sound basis for commission sharing arrangements.

➢ *The AFEI-AFG Charter and VAT treatment of commission sharing*

39. The tax treatment of shared commissions must be examined in light of the type of service that they compensate. The focus on the type of service rather than the status of the service provider is a principle used by the European Court of Justice 7 and was also taken up recently by French tax authorities8.

As stated in Principle 1 of the AFG-AFEI Charter, "The commission paid to a broker for a transaction initiated by an investment manager acting on behalf of its clients is compensation for the services of order execution and investment/trading decision support, as these services are inherent in and inseparable from brokerage."

Dealing commissions fall under the category of "transactions in securities". These transactions are, in principle, exempt from value-added tax (VAT) under Article 13 B-d-5 of the Sixth VAT Directive and under Article 261 c 1 *d* of the French Tax Code. However, in France, they may be liable for VAT at the service provider's discretion (Article 260 B of the French Tax Code).

Investment/trading decision support services must be considered as inseparable from the business of order execution in that they influence an investment manager's decision on whether to place a trade order with the broker. As a result, these services also fall under the category of transactions in securities regardless of whether they are provided by the broker itself or by another provider supplying services such as those listed in the Charter (research, financial analysis, etc.).

[7] CJEC, 4 May 2006 – Case C 169/04 Abbey National PLC – Recital 66
[8] Official proceedings of the AFEI-AFG conference on 27 September 2005, approved by the Tax Legislation Department, and tax instruction BOI 3 L-3-05

The Tax Legislation Department has not yet had an opportunity to issue an opinion on the status of investment/trading decision support services, as defined by the AFEI-AFG Charter, with respect to VAT. But in another field, that of collective investment management, the Conseil d'Etat, in its Sogefonds ruling of 6 April 2001, held that administrative and accounting operations are "inseparable" from the activity of managing a collective investment scheme, even if they are performed by an individual or entity separate from the investment management company itself. They are therefore exempt from VAT, unless the service provider opts to charge it.

The Tax Legislation Department adopted the same reasoning in paragraph 30 of Instruction 3 L-3-05 of 3 August 2005, regarding VAT on financial services. It stated that "*exemption f in 1° of Article 261 C of the French Tax Code covers the management operations inseparable from the activities of a collective investment scheme*". Similarly, the European Court of Justice's 4 May 2006 ruling in *Abbey National PLC* relied on the phrase "*form a distinct whole, and are specific to, and essential for, the management of special investment funds*" in order to categorise subcontracted administrative and accounting management services as "management".

Based on the reasoning used for collective investment, the Tax Legislation Department will be asked to confirm that investment/trading decision support services provided in accordance with the Charter will be subject to the same VAT regime as execution services.

Of course, a favourable decision by the Tax Legislation Department will not eliminate tax friction entirely. Just because a broker does not opt to charge VAT does not mean that the provider of investment/trading decision support services will do likewise. However, a range of options will be available and investment managers will be able to chose their supplier of investment/trading decision support services, in full knowledge of the risk of tax frictions vis-à-vis the broker with whom they have signed a commission sharing agreement.

B. – CONTENT AND SCOPE OF THE PRINCIPLES IN THE AFEI-AFG CHARTER

40. A number of factors can be put forward, in addition to the observations in the first part of this paper, to give a clearer idea of the content and scope of the Principles set out in the Charter. These factors, which actually rely on those observations in many cases, are discussed below.

Principle 1

The commission paid to a broker for a transaction initiated by an investment manager acting on behalf of its clients is compensation for the services of order execution and the investment/trading decision support.

41. "Investment manager" means the portfolio management companies referred to in Article 322-1 of the AMF General Regulation, i.e. those involved in collective investment management and those involved in personal investment management. Trades effected by trading subsidiaries of an investment manager are considered to have been initiated by the manager.

"Broker" means an investment services provider that executes orders on behalf of investment managers, whether through a third-party order execution technique *stricto sensu* (*AMF GR, art. 312-2*), or through an own-account dealing technique (*AMF GR, art. 312-4*). It applies to brokers using a third-party order reception/transmission technique (*AMF GR, art. 312-1*), provided they are "non-transparent" to the client, i.e. the client is not bound by contract to the trader, who, in practice, is a subcontractor of the principal.

42. When an order is executed by a broker, it gives rise to a commission as consideration for the service rendered. In practice, the commission is invoiced through the trade confirmation, which shows the terms on which the trade was executed, in compliance with the AMF General Regulation (art. 321-72, 3°).

The sums thus paid by investment managers constitute "intermediation costs" within the meaning of the AMF General Regulation (*art. 322-41, 1°*). As such, the commission is charged directly to the fund for which the trade was carried out.

43. Such commission is paid as consideration not only for the order execution service stricto sensu but also for a bundle of other services that some brokers "traditionally" provide for institutional clients. The AFEI-AFG Charter refers to these bundled services collectively as investment/execution decision-support services, insofar as they are part of the underlying decision to buy or sell financial instruments.

These investment/execution decision-support services constitute the scope of so-called "permitted" services, in contrast to "non-permitted" services, which cannot be purchased with dealing commissions.

The AFEI-AFG Charter does not delineate the content of permitted and non-permitted services, as explained above (see §27 *et seq.*). However, the Schedules to this Charter provide examples of execution services (*Schedule 3*), investment/execution decision-support services (*Schedule 4*) and non-permitted services (*Schedule 5*).

44. The Charter deals only with situations involving services related to trades in equity or equity-equivalent securities (see §36), although this has not been not expressly stipulated.

Principle 2

In a regular, organised service relationship, and where the total commission paid for the execution of trades initiated by an investment manager exceeds a sufficiently material threshold, the split between the compensation paid for order execution services and that paid for investment/trading decision support services is determined through a broker review conducted jointly by the investment manager and the broker.

45. As explained above (see §19 et seq.), the broker review is a key component of the AFEI-AFG Charter, since it is designed to lead to a shared understanding of the value of the services that the broker supplies to the investment manager.

In light of that value and the overall commercial relationship between the two parties, the investment manager will decide whether to continue purchasing some or all of the broker's services, and the broker will decide whether to continue supplying its services to the investment manager. Described in this way, and having regard to the broker's concern to allocate its resources effectively (see §16), the broker review is tantamount to an auction that establishes the price at which the broker is willing to provide its services and the investment manager is willing to buy them.

46. The AFEI-AFG Charter limits the scope of implementation of the broker review when "the total commission paid by an investment manager for trade execution exceeds a sufficiently material threshold".

The reasons for this general framework and the conditions for assessing it have already been explained (see §21 and 22) and need not be repeated here.

Principle 3

The broker review covers all aspects of the service relationship between the investment manager and the broker.

The broker review pertains to the services provided during a prior reference period agreed upon by the investment manager and the broker. Whatever the circumstances, the review should include at least one meeting per year between the two parties.

47. The broker review must be exhaustive and must apply to every aspect of the service relationship between broker and investment manager. (It must be reiterated, however, that the relationship is reviewed only if the services pertain to equity or equity-equivalent securities (see §36 and 44).

48. In practice, the broker review consists in examining all the services provided since the previous review or since the business relationship began. The period covered by the review is called the reference period.

The length of the reference period must be commensurate with the importance of the relationship. As a minimum requirement, the period is one year, but it may also be a half-year or even a quarter, if warranted by the intensity of the services provided (see §22). The length of the reference period is determined by agreement between the investment manager and the broker. It is obvious, however, that the larger the volume of commission, the more it is in the interest of both parties that the review be performed at sufficiently close intervals.

49. Clearly, a broker review with a one-year reference period must be suitably formal, with at least one meeting at which the broker and the investment manager can compare and contrast their views. Such meetings, which provide the opportunity for a face-to-face discussion, are vital to ensure that there is a genuine shared understanding of the value of the services provided.

By contrast, for shorter reference periods, broker reviews carried out on an intermediate basis can be more flexible, e.g. through a conference call or an exchange of documents.

50. It is recommended that the frequency of reference periods be adjusted so that each financial year is considered separately. Accordingly, where both the investment manager and the broker have a year-end at 31 December, this should be taken into account for the reference period.

Principle 4

When an investment manager and broker establish a relationship, they may carry out a forward-looking broker review.

51. This principle recalls that, since the broker review is an ex post mechanism, it is meaningful only from forward-looking standpoint when a broker and an investment manager first establish a business relationship.

This forward-looking discussion is especially important if the service relationship will result in the payment of a significant volume of commission. In any case, the discussion is necessary if the investment manager wishes to put in place a commission sharing arrangement to determine the amounts paid for execution and those earmarked for investment/trading decision support (see §53).

52. Since the discussion is forward-looking, it can be less formal than under normal circumstances. It need only form a sufficient basis for the subsequent first broker review.

Principle 5

The results of the broker review, inter alia, serve as a basis for establishing the nature of the services the broker will supply to the investment manager over the subsequent reference period, or any other agreed period, and the terms of compensation.

Both parties must keep a record of the review's conclusions.

53. The outcome of the broker review serves as the basis for agreeing upon the type of services that will be supplied during the forthcoming reference period, or any other agreed period, and the consideration that will be paid for them.

In practice, this consideration is assessed globally for each category of service supplied during the period in question, rather than for each transaction to which the service pertains.

54. A written record must be made of the outcome of the broker review and must be kept by both parties. This is not a contract in the proper sense of the term, since the aim is not to make the relationship even more formal. However, some form of proof is necessary in order to ensure the efficiency of the broker review.

Principle 6

The investment manager and the broker have the right to amend by joint agreement, before the end of the reference period, the organisational arrangements made in compliance with Principle 5.

55. The purpose of this principle is not self-evident from a purely legal standpoint, since both parties can still alter the terms that bind them, by mutual agreement. However, to avoid haziness on this issue, it was considered desirable to stipulate that the Charter does not seek to place inflexible limits on relations between investment managers and brokers during the reference period.

The parties are therefore free to alter the nature of their business relationship as warranted by the circumstances, e.g. the manager has changed its investment processes, or the broker is no longer able to provide the services as initially planned.

Principle 7

The investment manager can ask the broker, on condition that the broker provides at least order execution services, to rebate some or all of the commission paid on a trade to one or more third parties of its choice for the purpose of compensating investment/trading decision support services.
The terms of this third-party rebate by the broker must be formally established in a commission sharing agreement.
This compensation framework excludes a range of services, specified in a list.

56. Since commission sharing arrangements address a real need among market participants (see §23 et seq.), this principle of the AFEI-AFG Charter sets forth three conditions for implementing them.

First, commission sharing can be arranged only with a broker that provides execution services as a minimum (see §28).

Second, the consideration payable under the arrangement applies only to investment/trading decision support services, as explained above (see §28).

Third, the terms for making this payment must be established formally in a so-called commission sharing agreement (see §58).

Regarding the broker review, another prerequisite, see 60.

57. Where the services in question do not have to be supplied by a regulated entity, the beneficiary of a commission sharing arrangement need not be a broker.

Regarding third-party beneficiaries, see 34 *et seq.*

58. Commission sharing arrangements must be placed on a contractual basis. This does not necessarily require a specific agreement; it can be done by including a number of clauses in an agreement covering other matters.

However, for an agreement to qualify as a commission sharing agreement within the meaning of the AFEI-AFG Charter, it must include specific provisions. A list of minimum provisions is set out in Schedule 6.

59. There is no obligation to implement a commission sharing agreement. The investment manager and the broker are free to decided whether to do so (see §26).

Principle 8

A commission sharing agreement may not be implemented without a broker review.

60. Investment managers and brokers cannot enter into a commission sharing arrangement without a broker review. A broker review is an essential prerequisite because unless the value of the various services is clearly established, there can be no question of rebating to a third party a portion of the consideration paid through dealing commissions (see §26).

In particular, an investment manager that is not in one of the situations requiring a mandatory broker review (see §21, 22 and 46) but that wishes to implement a commission sharing agreement must nonetheless conduct a review.

Principle 9

A commission sharing agreement may be re-examined during each broker review or at any other time agreed by the investment manager and the financial intermediary; if need be, it may be amended.

61. A broker review can provide the opportunity to review the commission sharing agreement. A reassessment of the services and the terms on which they are provided should influence the commission sharing agreement. However, the agreement will not automatically be amended as a result.

Principle 10

A commission sharing agreement is intended to replace the system of soft commissions between the investment manager and the broker.

62. As explained above (see §32 et seq.), commission sharing agreements are intended to replace soft commissions.

Principle 11

The investment manager and the broker establish a reporting procedure to ensure that the manager is informed about the performance of the arrangements set out in the broker review and in the commission sharing agreement, if any.

These reports must be supplied at least once a year according to a schedule agreed by the investment manager and the broker.

63. The broker must report to the investment manager on the performance of the commission sharing agreement. The arrangements for making these reports must be set out in the agreement (see 58). A sample report is shown in Schedule 7.

SCHEDULE 1
MEMBERS OF THE WORKING GROUP

PLENARY GROUP

- ***Franck Becker*** (Deputy Chief Executive) – AGF Asset Management
- ***Hugues Bernamonti*** (Deputy Head of Equities Investment) - SG Asset Management
- ***Wenceslas Betolaud*** (General Counsel) - Exane BNP Paribas
- ***Pierre Bouhanna*** (Customer Relations Director) - Exane BNP Paribas
- ***Negib Bouhouita*** (Project Manager) – Axan investment Managers
- ***Bernard Coupez*** (Director) - BNP Paribas Asset Management
- ***Bernard Descreux*** (Director of Asset Management) – Sogeposte
- ***Didier Lemenestrel*** (Chairman) – Financière de l'Echiquier
- ***Boris Marchand*** (Chief Investment Officer) - Natexis Asset Management
- ***Thierry Morcillo*** (Chief Executive) – Morgan Stanley SA
- ***Jean Paul Pierret*** (Executive Director, Natexis Bleichroder) – Société Française d'Analyse Financière
- ***Bertrand Patillet*** (Deputy Chief Executive) – Crédit Agricole Cheuvreux SA
- ***Marie-Pierre Peillon*** (Head of Credit and Investment Research) - Groupama Asset Management
- ***Bertrand de Saint Mars*** (Deputy Chief Executive) - AFEI
- ***Philippe Tibi*** (Chairman) – UBS Securities France SA
- ***Charles-Henri de Tredern*** (Fund manager) – Oddo et Cie
- ***Vincent Zeller*** (Chief Executive) - Groupama Asset Management

Rapporteurs:

- ***Emmanuel de Fournoux*** (Director) – AFEI
- ***Eric Pagniez*** (Deputy Chief Executive) - AFG

* Working group members whose names are underlined were part of a select group, the Bridgehead Group, responsible for drafting proposals that were subsequently submitted to the plenary group.

TAX SUB-GROUP

- ***Claire Acard*** (Partner-attorney) – Ernst & Young Société d'Avocats
- ***Christophe Aldebert*** (Partner-attorney) – CMS Bureau Francis Lefebvre
- ***Jean-Claude Bouchard*** (Partner-attorney) - TAJ
- ***Nathalie Martin-Queulin*** (Attorney) - Landwell & Associés
- ***Emmanuel de Fournoux*** (Director) – AFEI
- ***Fréderic Ghidalia*** (Attorney, Director specialised in VAT) – Ernst & Young Société d'Avocats
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- ***Thierry Pons*** (Partner-attorney) – LPA Lefèvre Pelletier & Associés
- ***Bertrand de Saint Mars*** (Deputy Chief Executive) – AFEI
- ***Emmanuel Strauss*** (Head of tax affairs) - Natexis, Chairman of the AFEI Tax Affairs Committee
- ***Philippe Vaysse*** (Partner-attorney) - Landwell & Associés

Rapporteurs:

- ***Annick Montel*** (Head of Tax and Accounting) - AFG
- ***Eric Vacher*** (Tax advisor) – AFEI

SCHEDULE 2
THE UNBUNDLING MECHANISM ADOPTED IN THE UNITED KINGDOM

➢ ***A new system of compensation transparency came into force on 1 January 2006***

1. To enhance transparency for customers of investment management companies, the UK Financial Services Authority (FSA) published *Policy Statement 05/9* in July 2005. The new rules require investment managers to break down the dealing commissions they pay to brokers, identifying those used to purchase execution services and those that pay for "research" services [9]. The rules, which also outlaw soft commissions[10], came into force on 1 January 2006 with a transitional period until 30 June 2006.

➢ ***The new regulations result from lengthy consultations between the FSA and the industry***

2. The FSA issued Consultation Paper 176, '*Bundled brokerage and soft commission arrangements',* in April 2003. At the time, the FSA was concerned that the system of commission paid by investment managers to brokers was unsatisfactory, since some 40 per cent of the money was used to purchase services other than execution, i.e. research services and/or market data, pursuant either to full ("bundled") broking agreements or to soft commission arrangements. This lack of transparency prompted the FSA to reflect on the way that investment managers handle the conflicts of interest they may face if their clients are unable to identify the services purchased with commission. In particular, the FSA pointed out that soft commissions arrangements might encourage investment managers to make direct charges to their funds for services they would normally pay for themselves, and hence to choose brokers not on the basis of execution quality but on whether or not they accepted such arrangements.

To address the situation, the FSA proposed firstly to limit the range of goods and services beyond trade execution that could be purchased with commission and secondly to require investment managers to value the goods and services that could still be softed or bundled and to rebate an equivalent amount to their customers ("*the rebate proposal*").

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[9] This is a generic term that has a broader scope than the usual definition; it corresponds to the "investment/trading decision support services", as defined in the Charter of Good Practice.

[10] A soft commission arrangement is a mechanism whereby the broker pays for a service provided directly to the investment manager by a third party.

3. The FSA's proposals sparked intense debate with investment managers and, in particular, with professional associations in the UK. In May 2004, the FSA published the findings of its consultation and issued a new set of proposals (*Policy Statement 04-13*). It acknowledged that, despite a general consensus on the need for greater transparency regarding the type of commission paid by investment managers, the solutions outlined in Consultation Paper 176 were highly controversial. In particular, the professional associations argued that the rebate proposal was not economically relevant since it could adversely affect the UK investment management industry and undermine the economic viability of independent research houses. The FSA also noted that the proposals put forward by industry groups, especially the Investment Management Association, to introduce a disclosure regime to inform fund investors about the type of commission paid was an acceptable solution. Furthermore, the regulator took note of the development of commission sharing arrangements, stating that these could be a suitable alternative to soft commissions.

The FSA thus proposed a combined solution consisting of regulation and market-driven measures. In this respect, the professional associations undertook to come up with solutions to provide fund investors with more information about the type of services that investment managers purchase from brokers. They worked on developing conduct of business rules aimed at implementing the new transparency solutions.

4. Policy Statement 05/9 supplements these industry proposals. The aims of the new framework are to:

- ✓ limit investment managers' use of dealing commission to the purchase of execution and research services;
- ✓ require investment managers to disclose to their customers details of the services that have been acquired with commission payments,
- ✓ embed incentives in the commercial relationship between investment managers and brokers to secure value for clients for execution and research spend;
- ✓ promote competition between independent research companies and brokers that provide both execution services and research.

➢ ***The FSA's new regulations apply only to investment managers***

5. The FSA's new regulations apply only to investment managers, not to brokers. They are organised around three key principles:

- ✓ the former system of soft commission is abolished from 1 July 2006;
- ✓ execution services and research services have been defined;
- ✓ investment managers are required to make periodic disclosures to their customers about the type of commissions paid, breaking out those used to purchase execution services and those that pay for research services.

➢ ***The new rules introduce a system for classifying the services provided in respect of financial transactions***

6. To enable firms to distinguish between what they pay for execution services and what for research services, Policy Statement 05/9 gives generic definitions for these two broad categories of service.

- ✓ Execution relates to goods and services that 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*".
- ✓ Research relates to goods and services that are "*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*".

7. Conversely, the following goods and services do not meet the requirements for consideration as execution or research:

- *services relating to the valuation or performance measurement of portfolios;*
- *computer hardware;*
- *dedicated telephone lines;*
- *seminar fees;*
- *subscriptions for publications;*
- *travel, accommodation or entertainment costs;*
- *office administrative computer software, such as word processing or accounting programmes;*
- *membership fees to professional associations;*
- *purchase or rental of standard office equipment or ancillary facilities;*
- *employees' salaries;*
- *direct money payments;*
- *publicly available information*
- *custody services relating to designated investments belonging to, or managed for, customers other than those services that are incidental to the execution of trades.*

There is also a "grey area", notably as regards post-trade analytics[11] and raw data feeds[12].

[11] On this point, the FSA states "*Our view is that many of the new analytical IT products being developed (which are commonly called 'post-trade analytics') are not 'execution': for example, those products that provide information about the quality of markets generally (e.g., liquidity, market impact, comparisons of the trading of various brokers and the like against different benchmarks). While acknowledging that many of these services are useful or important to investment managers, we are not persuaded that these are valid reasons for including them in the goods and services which can be acquired with commission. So, we are staying with our existing policy approach. But we do recognise that information about how well a broker conducted a particular transaction or series of transactions for an investment manager could fall within the execution parameter. We also consider that, as many of the vendors of these services are not brokers, it is important to provide equal regulatory treatment as between brokers and third party providers*".

[12] These are defined as "*price feeds or historical price data that have not been manipulated or analysed in any way". On this point, the FSA says: "We continue to believe that raw data feeds should not be permitted as research*

8. Policy Statement 05/9 also stipulates that brokers are not responsible for ensuring that the goods or services acquired by investment managers fall within the permitted parameter. Responsibility lies with the management firm.

➢ ***Professional associations have prepared conduct of business rules to ensure transparency for fund customers***

9. One of the mainstays of the new UK system is its reliance on conduct of business rules drafted by professional associations to ensure transparency for fund customers. Due to the adoption of these rules, the FSA was able to avoid imposing overly restrictive regulations on investment managers and brokers. Three sets of rules have been issued by professional associations:

- ✓ *Statement of Good Practice* published by the London Investment Banking Association (LIBA), governing commercial relations between investment managers and the brokers represented by LIBA. It establishes a regular review process between the broker and investment manager, the main aim of which is to establish an indicative split between the execution and research components of commissions. The broker review also makes it possible to agree upon the amounts payable under commission sharing arrangements to third parties in return for services.
- ✓ *Pension Fund Disclosure Code*, published in March 2005 by the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF), which sets down rules for investment managers to inform their customers about the types of commission paid to brokers.
- ✓ *Unbundling and Soft Commissions Disclosure Arrangements for APCIMS' Members,* published in November 2005 by the Association of Private Client Investment Managers and Stock Brokers (APCIMS)

➢ ***Work in the UK continues***

10. The FSA and investment firms consider that work on the new framework is unfinished and must continue. In particular, the FSA wants professional associations to make a more detailed analysis of transparency rules for retail funds.

In addition, the FSA, LIBA, IMA and NAPF are due to start discussions aimed at measuring how the new regulations have actually affected the industry and ascertaining whether the objectives have been reached.

Furthermore, the FSA is dialoguing with the Securities and Exchange Commission about the definition of permitted services.

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services. Data that has been manipulated into some form of output may be research, as long as the tests set down in our rules are met. While we accept that raw data feeds play a role in helping firms to achieve best execution, we do not believe that this automatically makes them an execution service that can be paid for with commission. If investment managers choose to pay for a service that they believe assists them fulfil their regulatory obligation of best execution, then they should consider the most appropriate way to do so. So to the extent that a raw data feed meets our criteria for an 'execution service', it could be classified as such, but investment managers must be able to justify the decision to do so".

SCHEDULE 3
EXAMPLES OF EXECUTION SERVICES

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1. Advice on execution strategy

1.1. Market data supply

Brokers provide information about the state of the market, i.e. liquidity, investment flows and market participants active on a particular security or sector.

They make recommendations about the timing and method of order execution.

The relevance and value of this information depend closely on their share of the market and their ability to anticipate forthcoming movements.

Investment managers use these services to judge the optimum period between the investment decision and the moment the order is presented to the market, thus minimising opportunity costs.

1.2. Pre-trade analysis

Brokers provide forward-looking measures of market impact according to the size and timing of trades and they make recommendations on when and how to execute orders.

The value of the broker's analyses depends on its spend and investment in quantitative research.

This advice is particularly valuable for portfolio restructuring (sector restructuring, transition management), when investment managers are particularly anxious not to destroy value.

These analyses enable brokers to propose the optimum trade-off, on average, between the risk of triggering a significant market impact by executing an order rapidly and the risk of volatility, which is an increasing function of time.

2. Execution services

2.1. Direct market access

Brokers provide their clients with systems for direct access to one or more markets.

Direct market access, or DMA, is generally reserved for orders with little or no market impact or for investment managers wishing to trade anonymously. In this case, the manager assumes most of the responsibility for the outcome.

2.2. Algorithmic and programme trading

Brokers offers algorithmic and programme trading services. The quality of these services hinges on the performance and variety of the algorithms in light of the client's objectives and the types of market, and also on their stealth and customisation. The services make it possible to preserve client anonymity, to access the market rapidly and to track its movements without human intervention ("smart routing").

Combined with DMA, both algorithmic and programme trading meet the same objectives but with more sophisticated tools supplied by the broker.

2.3. Order execution by the broker's trading desk

The intensity of a broker's service depends on the level of responsibility it assumes. It can determine and implement an execution strategy (for discretionary orders) or simply advise the investment manager (see above), which then chooses the strategy itself and delegates implementation to the broker. In any case, the client must be kept informed of events that might affect execution so that the strategy can be adjusted to changing market conditions.

Execution quality is measured by comparing the traded price with the target price, i.e. its benchmark (opening price, closing price, volume-weighted average price) relative to the liquidity ratio.

2.4. Natural crossing

Relying on its knowledge of clients' portfolios, the broker is able to find the natural counterparty for an order without having to present it to the market and can execute it, at least partially, without impact at the market price.

The broker's value added can be measured immediately and is all the more significant if the order accounts for a percentage – or even a multiple – of the daily liquidity traded on the official markets.

2.5. Facilitation

The broker relieves investment managers of execution risk by immediately buying or selling against their orders for its own account. By accepting the risk of price swings, brokers commit their own capital. They generally unwind the position in the market and thus assume the implicit transaction cost (market impact /volatility risk)

Since order facilitation is structurally loss-making for the broker, it can be seen in economic terms as a commission rebate that directly benefits the managed portfolio. The value added for the investment manager is calculated on the difference between the traded price and the weighted average price that would have been obtained if the order had been executed on the market with a participation rate of 25 or 33 per cent (the generally accepted method).

3. Transaction follow-up: confirmation, reporting, settlement

Dealing commissions cover the expenses incurred by the broker to provide post-trade services. These expenses increase in line with the scope of the services provided: timely reporting by the investment manager using the requisite format; compliance with theoretical settlement dates (automatic stock lending); tools for real-time dissemination of settlement status.

SCHEDULE 4
EXAMPLES OF INVESTMENT/TRADING DECISION SUPPORT SERVICES

These services can be provided both by brokers and by market participants with no specific regulated status.

1. Research

1.1 Microeconomic, or company, research (see previous analysis)

Investment services providers (ISPs) give investors access to teams of analysts organised by industry sector and charged with researching investment opportunities.

The methods generally proposed consist in selecting stocks on the basis of one or more specific approaches, such as:

- discounted future cash flows
- economic value added
- sum-of-parts valuation
- comparing companies on the basis of ratios, e.g. enterprise value / sales
- EBITDA margin
- return on equity
- gearing

The analyst builds a valuation model, drawing on his or her knowledge of a company's sector and business, its growth prospects and the risks inherent in its strategy, with a view to determining the upside potential for its shares.

Valuation methods are often sector-specific: for example, a banking stock is not valued in the same way as an industrial stock. For this reason, brokers that provide this service generally seek to offer the broadest possible range of competencies within their research departments.

Analysts regularly update their valuation assumptions in light of market information and regular contacts with the companies they follow.

1.2 Sector research

Produced generally once or twice a year, this research comprises a whole range of forecasts for a particular sector or industry, covering factors such as sales growth, earnings per share, and return on equity.

The aim of these reports is to provide corporate and institutional investors with a summary overview of trends in that sector or industry.

The reports are at least 50-60 pages long and take between one and two months to compile. The analyst needs to have privileged contacts with all the companies operating in the sector under review.

1.3 Macroeconomic research

Some ISPs have teams specialised in researching economic trends, generally focusing on the following parameters:

- analysing the main economic aggregates (GNP, inflation, debt, deficits, etc.)
- monitoring investment flows
- monitoring and forecasting long-term and short-term interest rates
- monitoring and forecasting exchange rates
- following trends in commodity prices

The aim of this research, generally produced once or twice a year, is to draw up economic forecasts for each geographical area in order to identity the best investment environments.

In addition, some ISPs produce occasional reports on specific issues such as the political or economic situation in a country as a result of elections, business cycles, and so on.

1.4 Investment strategy research

This research is used to determine asset allocations and strategic investment choices for each sector.

- Asset allocations: for each geographical area, the analyst compares data in order to establish the respective weightings for bonds, equities and cash.

- Strategic investment choices: this activity consists in issuing decisions on whether to go overweight or underweight each sector, e.g. overweight telecoms, underweight consumption.

Overall strategy notes are published twice a year, often supplemented by special market updates.

Strategy teams, usually with at least four or five members, are also responsible for determining the investment themes, such as value, growth, or defensive, that will help institutionals to outperform the market.

1.5 Methods for accessing research (web, hardcopy)

Many ISPs, and particularly brokers, set up a research website, which investors can access free of charge by means of a personal password.

The site contains all the research published by the ISP, organised by company, into equity and fixed-income products, strategy, currencies and economics. It includes a variety of search engines in order to respond more precisely to the demands and needs of each investment manager.

Research is also available in hardcopy form. In this case, it is sent to investors, which can make their own preselection of the reports they wish to receive.

Investment managers and analysts can also receive all the ISP's research by e-mail.

1.6 Research formats: reports, morning notes, flashnotes, etc

Research formats vary according to the sector and topic under review. They are also tailored to the needs and strategies of specific types of investor, such as hedge funds.

Analysts usually publish a specialised daily document for each sector, summarising the day's potentially price-moving events. These reports are an excellent management tool for investors – especially hedge funds – with very short-term horizons.

Research teams also publish in-depth reports:

- when reinitiating coverage of a stock
- when changing a recommendation, based on a strong conviction about trends within a sector or about a change of strategy and/or the parameters of a stock that prompts them to radically alter their estimates

Analysts generally publish short reports commenting on specific or one-off events such as results announcements. These "flashnotes", as they are usually called, may be followed up by a more detailed report.

2. Investment research: production, access to analysts

Analysts regularly update the models used to value the stocks that they cover. Available on the ISP's research website, these models and their underlying assumptions are regularly described in research publications. In addition, institutional and corporate investors can obtain analysts' models and data files on request.

A team of between two and four people is needed to provide regular coverage of a sector.

Analysts routinely contact investment managers and specialised buy-side analysts by phone. Their main aim is to make an investment case. They also provide information about events that could have a meaningful impact on the stocks they follow. Analysts publish their contact details along with their research so that they can be reached by e-mail or phone.

In the case of brokers, general investment managers are generally contacted by sales staff, who can put them in touch with analysts if they so wish.

Regular meetings are organised between investors and analysts. Buy-side analysts and managers thus benefit from a one-on-one discussion that allows them to obtain more information about an investment case, a sector or a stock more easily than by phone. This is an additional service that complements written research. Meetings are organised three or four times a year, or at the specific request of investors, so that analysts can share their knowledge on a personal basis.

3. Advice and sales services

At a brokerage, this service is provided by a salesperson. The main function of sales staff, who are generally university or business school graduates, is to sift through the output of the research department and choose reports that are likely to interest the client. This is important because each manager pursues an approach that corresponds to its own investment objectives (e.g. short-term, long-term, value, growth, small and mid caps, etc.).

The salesperson summarises the research report, highlighting the main points and helping managers to time the market. Market timing is crucial when seeking to outperform the market.

Through their regular contacts with other functions at the brokerage (market making, sales-trading, etc.), and with international clients, sales staff try to read the near-term market trend and thus help the client to delay its investment by several hours or days, giving their performance an extra percentage edge.

Sales staff also act as the interface for investment managers, organising meetings with companies or with visiting foreign analysts.

Furthermore, depending on their market knowledge, senior sales staff are able to recommend a particular stock without referring to the latest research, simply because its issuer has released a profit warning, or because the share has given a strong technical buy or sell signal or reached a particularly attractive level for purchases or sales. In such cases, salespeople fulfil their role by alerting the investment manager to these opportunities.

4. Access to companies and senior management

ISPs, and brokers in particular, can offer investors a general marketing service, with several components:

- The ISP can organise group visits or one-on-one meetings so that investors can form their own opinion on the quality of the people who manage the company they wish to invest in. For an industrial firm, it can organise factory visits with a view to giving investors a better understanding of the company's business and key challenges.

- The ISP provides access to seminars or presentations on specific topics (e.g. a meeting with the European Central Bank governor on monetary policy), sectors (e.g. basic metals), regulatory events (transition to IFRS) or countries (presentation of Dutch companies).

5. Transaction cost analysis

ISPs can provide tools for calculating implicit execution costs and analysing strategies *ex post* to optimise the relationship between market impact and volatility risk.

SCHEDULE 5
EXAMPLES OF SERVICES
THAT DO NOT QUALIFY AS PERMITTED SERVICES

The AFEI-AFG Charter of Good Practice posits the principle that the fees paid to brokers for trade execution are compensation for execution services and investment/trading decision support services only. Accordingly, no such commission can be paid for services that fall into neither of these two categories.

These services are referred to collectively as "non-permitted services", in contrast to "permitted services". This does not mean that investment managers cannot purchase the services but that they are not permitted to charge the cost to their funds, as they can do with dealing commissions.

The definition of non-permitted services is a key topic in the discussions being held at both the FSA and the SEC.

Some services obviously fall into the non-permitted category. For instance, those listed by the FSA are:

- services relating to the valuation or performance measurement of portfolios
- computer hardware
- dedicated telephone lines
- seminar fees
- subscriptions for publications
- travel, accommodation or entertainment costs
- office administrative computer software, such as word processing or accounting programs
- membership fees to professional associations
- purchase or rental of standard office equipment or ancillary facilities
- employees' salaries
- direct money payments
- custody services

In light of this, the working group paid particular attention to the status of trade analytics and to whether such services can actually be included in either category. After much discussion, and having regard to the solution adopted in the UK, the group believes they should be classified as investment/trading decision support services so that they can come under a commission sharing arrangement.

Extract from the FSA Policy Statement 05/09

"*Our view is that many of the new analytical IT products being developed (which are commonly called 'post-trade analytics') are not 'execution': for example, those products that provide information about the quality of markets generally (e.g., liquidity, market impact, comparisons of the trading of various brokers and the like against different benchmarks). While acknowledging that many of these services are useful or important to investment managers, we are not persuaded that these are valid reasons for including them in the goods and services which can be acquired with commission. So, we are staying with our existing policy approach. But we do recognise that information about how well a broker conducted a particular transaction or series of transactions for an investment manager could fall within the execution parameter. We also consider that, as many of the vendors of these services are not brokers, it is important to provide equal regulatory treatment as between brokers and third party providers*".

However, the AMF must now set out its position on this issue, bearing in mind that if differs from the FSA's stance, the economic consequences for brokers and investment managers could be serious. For this reason, the Committee of European Securities Regulators should work on harmonising the rules on permitted and non-permitted services.

SCHEDULE 6
CONTENT
OF A COMMISSION SHARING AGREEMENT

To qualify as commission sharing agreements within the meaning of the AFEI-AFG Charter (***Principle 7***), the contractual arrangements between a broker and an investment manager, be they specific agreements on commission sharing or contracts with a broader scope, must contain minimum provisions that accomplish the following:

a. establish that the agreement comes within the framework laid down by the AFEI-AFG Charter;
b. establish that the dealing commissions paid to the broker compensate investment/trading decision support services as well as execution services;
c. establish that the investment manager wants to use a portion of the commission to pay for investment/trading decision support services provided by third parties;
d. establish that, for the investment manager, these services are inextricably linked to execution services;
e. establish that the broker and the investment manager have put place in a broker review to determine the compensation that will be paid for the services provided by the broker;
f. set the frequency of broker reviews;
g. establish that the broker review is a precondition for entering into the commission sharing agreement;
h. determine how the broker is informed about the third parties to whom it must rebate a portion of its commission;
i. determine how the broker is informed that the third parties to whom it must rebate a portion of its commission have been duly notified that the services they provide to the investment manager will be paid for by the broker;
j. establish that the investment manager has sole responsibility for choosing third parties and that the broker is not responsible for ensuring that the goods or services acquired by the investment manager qualify as permitted services;
k. determine the conditions for calculating the amount that may be rebated to third parties in respect of investment/trading decision support services;
l. set the terms for third-party payments, especially frequency of payment;
m. determine how the broker informs the investment manager about the payments it has made and the beneficiaries thereof;
n. set the conditions for terminating the agreement, particular where the broker review is not held on schedule.

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SCHEDULE 7

STANDARD COMMISSION SHARING REPORT ON TRANSACTION COSTS

CLIENT
Address

Commission sharing account
Period: from… to …
Amount in EUR

	{1}	{2}	{3}	{4}	{5}	{6}	{7}	{8}
	Transaction costs (ex VAT)	**Fees paid to the initiating broker**	**Available balance**	**Services paid for by a third party to the initiating broker**	**Payments to the initiating broker for other services**	**Payments to third parties for services**	**Total for the initiating broker (2+4+5)**	**Balance available for appropriation by the investment manager (3-5-6)**
Month								
January	2,000	800	1,200		500	400	1,300	300
February	4,000	1,600	2,400				1,600	2,700
March	3,000	1,200	1,800		2000	600	3,200	1,900
April	-	-	-	500	-		500	1,900
December								0
TOTAL:	**9,000**	**3,600**	**5,400**	**500**	**2,500**	**1000**	**6,600**	**0**

Commission sharing account statement
Date of statement: 01 Jan-05

Definitions

{1} **Transaction costs**: Total commission (ex VAT) paid to the main broker for trading in cash instruments (DMA, AES, programme and cash sales-trading)

{2} **Fees paid to the initiating broker**: Portion of the commission paid in respect of execution at the pre-arranged rate

{3} **Available balance**

{4} **Services paid for by a third party to the broker:** Payments from other brokers in respect of decisions arising from the investment manager's internal broker assessment procedure

{5} **Payments to the initiating broker for other services :** Portion of the commission allocated by the investment manager to pay for other services provided by the broker (according to a broker's internal procedure)

{6} **Payments to third parties for services**: Portion of the commission allocated by the investment manager to pay for other services from third parties (according to a broker's internal assessment procedure)

{7} **Total for the initiating broker**: Sum of the commission paid for execution, other services provided by the broker, and all external payments by cheque

{8} **Balance available for appropriation by the investment manager:** Provisional difference between column (3), after payment of (5) and (6)