



EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

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EFFAS on the Unbundling of Financial Research

Dear Mr. Wright,

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national analysts societies. It comprises 25 members representing more than 14,000 investment professionals in the areas of Equity and Bond Research, Asset and Portfolio Management as well as Investment Advice.

The EFFAS Market Structure Commission (MSC) is a standing commission of experts under the aegis of EFFAS. The MSC aim is to propose and comment on regulatory issues from an analyst standpoint.

Financial research is in many cases a service which is not remunerated by a separate payment which the recipient of this research pays to the provider, but rather is bundled with other services. The remuneration for those other services is calculated in a manner to compensate also for the financial research provided.

This bundling and the ensuing lack of transparency raises issues, in particular, in the following areas:

- management of conflicts of interests
- transparency and justification of inducements
- best execution.

In the past, there have been repeated attempts to address the question of research bundling on the European¹ and National² level. The industry has taken position that no regulation of this topic was necessary. The commission has accepted this position.³

¹ Communication from the Commission to the Council and the European Parliament on investment research and financial analysis of 12 Dec 2006 (COM(2006) 789 final) FN 42

² UK FSA Consultation Paper 176 of April 2003 Bundled Brokerage and Soft Commission Arrangements and Consultation Paper 05/ 5 Bundled brokerage and soft commission arrangements: proposed rules

³ see FN 1 Communication at the end

Two European Directives, MAD and MiFID, address directly or indirectly these issues.⁴ Although the Commission presently sees no need for additional legislation concerning the unbundling of research from other services, it might be helpful to discuss the influence of the new provisions of MiFID on industry practices in changing the prevailing bundling practices. In the Commission's own words: "The receipt and provision of 'softed' and 'bundled' research can continue beyond implementation of the MiFID, only if it can be duly justified and shown to pass the strict tests in the legislation."

Management of conflicts of interests

Conflicts of interests in the provision of financial services arise in different relations:

Investment firm – investor clients

investment firm – issuer clients

investment firm – staff members

staff members – clients

clients - clients

Conflicts of interests can also be perceived in the relation research firm - issuer. These conflicts are, however, not influenced by bundling or unbundling of the investment services rendered to the investor side and may be ignored in this context.

Inducements not paid by or on behalf of the customer are only permissible if they are disclosed to the customer, designed to enhance the quality of the services provided to the customer and are in the best interests of the customer.⁵

The short term "Best execution" means that firms must execute client orders on terms most favourable to the clients.⁶ This requirement has been extended to introducing intermediaries (RTO firms, i.e. firms receiving and transmitting orders, and portfolio managers).⁷ For retail clients, the best possible terms or the best interest of the client is the best total consideration for a transaction (price and transaction cost).⁸

Intermediaries may be in the following situation:

1. Introducing broker (RTO firm or portfolio manager) – not dealing on own account – contractually linked to one broker only – broker provides research free of charge

1.1 Conflict of interest:

Normally, no conflict of interest exists. Research is additional information.

On the level of the intermediary, a conflict of interests may arise. However, in those cases only where such bundled software/ service paid for by all customers is used to the benefit of one group of customers and to the detriment of customers not belonging to this privileged group. The discrimination between customers is, however, justified when an RTO firm differentiates between a combination of advisory services with RTO business and non advisory services providing RTO service only. In the latter case, one may assume that the RTO firm (firm receiving and transmitting orders) will charge different commissions to the different groups of customers. Therefore, the non-advisory customers do not pay to the RTO firm for the bundled research provided to this firm. The conflict of interests

⁴ Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) and Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments

⁵ Art. 26 Par. 1 lit. b Directive 2006/73/EC

⁶ Art. 21 Directive 2004/39/EC

⁷ Art. 45 Directive 2006/73/EC

⁸ Art. 44 Par. 3 Directive 2004/39/EC

remains, however, on the level of the execution broker on the condition that all customers of the executing broker must pay the same brokerage fees for the transaction, in which presumably the cost for the research delivered has been included, regardless of whether the customer uses only the RTO services of the intermediary firm (non-advisory service).

Depending on the fact scenarios, the RTO firm must identify and disclose these conflicts in its conflict of interests policy.⁹

1.2 Inducement:

Financial research as inducement is designed to enhance the quality of the service of an intermediary firm where used for all customers who pay directly or indirectly through higher commissions for portfolio management or advice based on this research.

The receipt of research as non-monetary inducement must be disclosed to the client. The disclosure must state that the intermediary receives bundled research from a broker or an executing firm. But beyond the existence, also the nature and the amount, and where the amount cannot be stated, the method of calculating must be disclosed.¹⁰ The extent of disclosure for a non-monetary benefit is not clear. Since the cost of the benefit is included in the transaction charges (commission), the amount cannot be stated. It varies with the number of transactions affected by this bundling commission. At the most, the disclosure of the calculation of the commission and the part that is allocated to the bundled research may be required. It is doubtful whether this disclosure of the calculation of commission is useful information for the client. It does not really make the value of bundled research transparent because the customer does not know the total number of transactions burdened with the additional cost. If research were unbundled and adequate consideration were paid, no disclosure would be necessary because research properly paid for is not to be treated as an inducement.

Where an intermediary firm discriminates between customer groups without reflecting the discrimination in a differentiated commission structure, the inducement is not designed to enhance the quality of the services provided to the non-privileged customers. The bundled provision and use of research is not permitted.

1.3 Best execution:

The total cost to the client for the transaction carried out for the client, excluding the commission or remuneration paid to the intermediary, must be competitive. If this is not the case because the broker has calculated the cost of research into the commission charged for the individual transaction, unbundling might make best execution possible.¹¹

One could think of a scenario in which the broker or executing firm calculates and charges research separately to the intermediary (unbundling), who in turn includes this cost as a factor in calculating his remuneration to the client or it is irrelevant whether this research is acquired from the executing broker or from any other provider.

When the cost for research is separately charged by the broker, one must, however, first determine whether the price paid by the intermediary to the broker for research becomes part of the total cost for a transaction which determines the best execution for a retail customer. According to the Commission Directive 2006/73/EC Art. 44 NR. 3, the total consideration is represented by the price of the financial instrument and the costs related to execution including all expenses incurred by the client which are directly related to the

⁹ Art. 21 s. Directive 2006/73/EC

¹⁰ see FN 5

¹¹ According to the FSA CP 176, Executive Summary, it is estimated that up to 40% of the brokerage commission might be related to the bundled services like financial research.

execution of the order. The service of financial research, which by definition¹² is not intended for any particular individual transaction, but rather for distribution channels or for the public, is not directly but only indirectly related to the execution of an order. It may serve as the basis of a individual recommendation. But even this individual recommendation is not part of the execution or order placing process, but a dispensable factor leading to an execution or placement of an order.¹³ Therefore, separately charged financial research must not be included into the total consideration when determining “best execution“.

Thus an unbundling of financial research and a separate pricing of this service could make the consideration for execution of an order competitive under the requirement of “best execution“.

2. Intermediary - not dealing on own account – not contractually linked to one broker – one broker provides research free of charge.

2.1 Conflict of interest:

Prima facie, no conflict of interests exists. This research is additional information, provided the intermediary uses the research for the benefit of all customers.

In all other cases, the conflicts issue arises as in the fact situation described under 1.1. above.

2.2 Inducement:

The research provided free of charge is considered an inducement. It is an additional service to obtain transaction business from the intermediary. This inducement is designed to enhance the quality of the service when reflected in a differentiated commission structure as described above.

Unlike a higher commission rebate to the intermediary firm, the research is not likely to cause a conflict of interests because the intermediary can use this research only for the benefit of his clients. It can even be used for those customers whose transactions are steered to other execution channels. The provision of research is a legitimate tool for the broker to acquire transaction business.

This inducement must, however, be disclosed to the client, regardless of whether it results in a conflict of interests or not.

2.3 Best execution:

The same aspects are to be considered as in situation Nr.1.3 above. If the bundling leads to a higher total transaction cost for the client, the intermediary firm might have to refrain from using this broker, whereas research unbundled and paid for by the intermediary firm and forming a cost item for the calculation of remuneration for portfolio management or advice should be admissible and not influence the cost criteria under the requirement of “best execution.“

One might question this conclusion with the argument that the service with bundled research compared to a service without research provided are two different forms of execution, which may not be compared for purposes of best execution. Taking such a position, one could only compare bundled services of one firm with bundled services of another firm and in contrast unbundled services of different firms.

¹² Art. 24 Commission Directive 2006/73/EC “‘investment research’ means research or other information recommending or suggesting an investment strategy, explicitly or implicitly, concerning one or several financial instruments or the issuers of financial instruments, including any opinion as to the present or future value or price of such instruments, intended for distribution channels or for the public,“

¹³ See also discussion in FSA CP 05/5 “The scope of execution“ 2.11 ss.

We do not think this a valid argument. This is mainly due to the fact that in practice one does not find a commission structure differentiating as to whether in a particular transacting the financial instrument is affected by the research provided in bundled form.

The cost of research is spread through a generally higher commission rate, equally over all transaction, regardless of whether the instrument in question was covered by research delivered in bundled form.

Therefore, bundled research affects “execution“. An execution channel which becomes costlier due to bundled research must be avoided by an intermediary firm. The intermediary must instead use a firm charging lower commissions and acquire, if necessary, the research in an unbundled manner against proper consideration. It may then offer its own services to the customers with a higher charge to the client, in the case of an RTO firm preferably differentiating between advisory and non-advisory services.

3. Intermediary deals also on own account and receives relevant research free of a separate charge (bundled).

3.1 Conflict of interests:

These are scenarios in which potential conflicts of interest between firm and customer are obvious:

The crudest case of neglecting customers' interests is the use of the bundled research for the investment firm's own dealing only. The customer does not benefit from the bundled research service for which he does, however, pay, through the commission which is charged to him by the executing firm bundling the research.

Comparable is the case in which those responsible for the firm's own dealings receive and use the bundled research ahead of customer advisors.

A similar scenario is the case in which the intermediary firm's own dealing transactions are subject to lower commission rates by the bundling broker than retail customer transactions, although the bundled research is used for all transactions.

Such conflicts of interests must be identified in the firm's conflicts of interests policy and disclosed to the customers. The described practices are not permitted. The intermediary firm and the executing broker must establish safeguards against them.

3.2 Inducements

The bundled research is an inducement from the executing firm to the intermediary firm. It must be disclosed.

If used for all customers eventually paying for it, as additional information it is designed to enhance the quality of the service.

It does not give rise to a conflict of interests if own dealing transactions are not privileged against customer transactions with respect to commissions or other financial charges or to the timing of the availability of the research information and recommendation.

3.3 Best execution

As stated above, only unbundling might make “best execution“ possible in those cases in which transaction cost, including the cost for bundled research, make the execution channel uncompetitive.

4. An additional scenario are intermediaries whose staff members or firms to which they have outsourced certain functions (insourcers) and/or their staff members are permitted to deal in financial instruments for which the employer offers its services to customers.

4.1 Conflicts of interests

Provided the staff members or insourcers have access to bundled research received by the firm, similar conflicts arise as in the scenario of own dealings of the firm.

When and if the firm is dealing on its own, there is an additional conflict of interest between the staff members on the one hand and the firm on the other. This is, however, a conflict of interests which is not connected with the bundling or unbundling of research, but rather with the possibility to receive and abuse privileged information and recommendation contained in such research.

The firm must identify and disclose actual or potential conflicts of interests between customers and staff members, insourcers and their staff and must establish procedures for preventing the use of the bundled research by these staff members or related parties for their own benefit to the disadvantage of the firm's customers. These conflicts might relate to bundling (who pays for the research used by those staff members?) or not be specific to bundling.

4.2. Inducements

There are no particular issues beyond those discussed above.

4.3 Best execution

There are no particular issues beyond those discussed above.

5. Summary:

The issue of bundling or unbundling is not necessarily affected by the requirements which MIFID imposes on the identification, disclosure and handling of conflicts of interests and on the treatment of inducements. These provisions protect and benefit customers also in the case of bundled research. Unbundling might lead to more transparency and might, therefore, ease the firms' task to comply with these provisions. This is particularly true for the disclosure of the "amount" or the method of calculating the amount of a "non monetary" benefit. Unbundling eliminates these issues.

The industry might, however, be pressured into unbundling research and treating research reports as a properly calculated product which will be offered against a separate, therefore transparent, and adequate consideration, and will be paid for by intermediary firms due to the requirements of "best execution". Bundling research means including its cost into transaction costs and fees charged by the provider of this research. If the total of this transaction cost is higher than the cost charged by non-bundling competitors, the bundling firm might bundle itself out of retail transaction business.

Yours sincerely,



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