Financial Conduct Authority

Wholesale sector competition review 2014-15

February 2015

Feedback Statement

FS15/2

Contents

In this Feedback Statement we report on the main themes arising from the responses to the call for inputs for the wholesale sector competition review. We also set out the next steps for the review, including the topic selected for our first wholesale market study.

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Abbreviations used in this paper

AMC	Annual Management Charge
CCP	Central counterparty
CFD	Contract for difference
CMA	Competition and Markets Authority
CSA	Commission sharing agreement
DCM	Debt capital markets
DWP	Department for Work and Pensions
ECM	Equity capital markets
EMIR	European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
FICC	Fixed income, currencies, and commodities
IPO	Initial public offering
Libor	London Interbank offered rate
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
OFT	Office of Fair Trading
OTC	Over the counter
PRA	Prudential Regulation Authority
RDR	Retail Distribution Review
SME	Small and medium-sized enterprises
TER	Total expense ratio
TMAS	Treasury Management Advisory Services

1. Overview

Introduction

1.1 The Financial Conduct Authority has a strategic objective to ensure that the relevant markets[1] function well. To support this, we have three operational objectives:

- To secure an appropriate degree of protection for consumers;
- To protect and enhance the integrity of the UK financial system; and
- To promote effective competition in the interests of consumers.

1.2 We also have a competition duty to promote effective competition when addressing our consumer protection or market integrity objectives. From 1st April, our competition remit will cover competition issues beyond our regulatory perimeter and we may seek to address such issues ourselves or by working in collaboration with the UK and EU competition authorities.

1.3 Wholesale financial markets play a vital role in our economy, and it is important that competition works effectively within them. In June 2014 the Chancellor launched the Fair and Effective Markets Review with a focus on conduct in fixed income, commodity and currency wholesale markets. In July 2014 we launched a review of competition in the wholesale sector to gather views on areas that might benefit from further investigation through an in-depth market study.

1.4 Market studies are an important tool for examining how well competition works in financial markets and help us assess whether we should intervene in the interests of their users.

1.5 Effective competition creates incentives for firms to operate as effectively and efficiently as possible, for example by cutting prices, increasing output, improving quality or variety, or introducing new and better products, often through innovation.

1.6 Based on the feedback we received, we intend to launch a market study on investment banking and corporate banking services in spring 2015. We will publish further information, including a terms of reference, and contact relevant firms in due course. This feedback statement:

- Explains why we have chosen this topic for our first wholesale market study;
- Sets out timescales and next steps; and
- Summarizes the wider responses we received to the call for inputs and our view on conducting further market studies on these topics.

1 The relevant markets include the financial markets and the markets for regulated financial services s1B(2) FSMA.

1.7 During the consultation period we met around 70 organisations and individuals, through a combination of round-tables and one-to-one meetings. We also received 40 written responses from a wide variety of stakeholders, including regulated firms, consumer organisations, trade bodies, and consumers. The main themes they raised are set out below:

- A lack of transparency of investment and corporate banking services;
- Asset managers' ability and incentives to control costs along the value chain;
- The pricing and availability of data and related services;
- Vertical integration of clearing and execution services; and
- The impact of a reduction in the number of clearing members and a lack of client clearing on over-the-counter (OTC) derivative markets.

1.8 We will consider undertaking a market study into asset management and related services later in the year. However, for the other potential competition issues identified, it is expected that forthcoming regulations will affect the way competition works, so there are no immediate plans to conduct further studies into these areas.

1.9 This feedback has given us a greater understanding of potential competition issues within the wholesale sector, and reflects a specific request for stakeholders to raise concerns. Chapters 2 - 5 summarise this feedback in more detail, setting out the features that are likely to affect competition in each sector and comparing these to our approach to prioritising markets studies.

1.10 It is important that these summaries are read in the context of wider work in wholesale markets, such as the Fair and Effective Markets Review[2], and our other supervisory and policy initiatives to ensure these markets work well.

Call for inputs

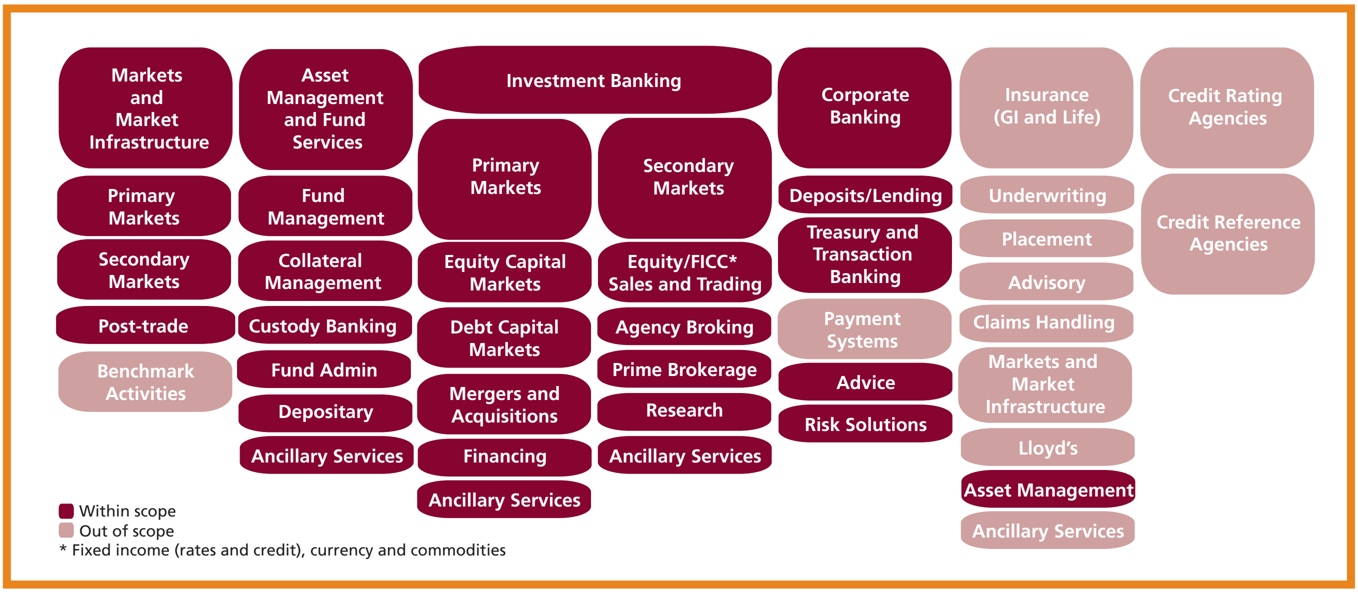
1.11 We published a call for inputs as part of the review in July 2014, to seek views from stakeholders on areas where competition may not be working effectively.

1.12 We explained that the review would focus primarily on competition in wholesale securities and investment markets, and related activities such as corporate banking. To keep the scope of the review manageable, we excluded other areas such as payment systems, credit rating agencies and wholesale insurance. We also noted that the review would not focus on trading practices, including benchmarking activities, which are within the scope of the Fair and Effective Markets Review.

2 The Fair and Effective Markets Review (FEMR) was established by the Chancellor in June 2014 to conduct a comprehensive and forward-looking assessment of the way wholesale financial markets operate, help to restore trust in those markets in the wake of a number of recent high profile abuses, and influence the international debate on trading practices. For further information please visit: www.bankofengland.co.uk/markets/Pages/fmreview.aspx

1.13 Figure 1, below, illustrates which areas were covered by the wholesale sector competition review, with the lighter shaded areas outside the scope.

Figure 1 – Scope of the wholesale sector competition review



1.14 To aid discussion, we set out examples of potential competition issues that had been raised with us previously or drawn from our internal research, for example through supervisory or thematic work. These included:

- Topics relating to markets and market infrastructure:
  - issues relating to the production and dissemination of data;
  - arrangements between trading venues and clearing houses;
  - packaging of trading and clearing services by dealers;
  - the availability of client clearing;
  - concentration in the OTC and venue-traded markets; and
  - co-location.
- Potential competition issues relating to investment banking activities:
  - cross-selling and transparency of investment banking services;
  - cost of equity and debt underwriting; and
  - best execution.

- Potential competition issues relating to asset management:
  - The incentives of asset managers to pay the correct price for the correct level of service when making purchases on behalf of fund investors.
- Topics relating to corporate banking:
  - likelihood of entry;
  - demand for corporate banking; and
  - cross-selling.

1.15 We asked respondents to give us their views on whether these potential competition concerns were borne out in practice. We also asked whether there were other areas within the scope of the review where competition was not working effectively.

Prioritisation of market studies

1.16 In deciding whether to conduct a market study in a given area, we have considered the responses received, undertaken our own analysis, and explored relevant academic research and industry publications.

1.17 We have analysed the issues against the following criteria for prioritisation, set out in the call for inputs:[3]

- The prospects for and likely impact of any intervention in the market – including the scale of harm, the scope for the FCA to intervene effectively and the prospects for read-across to other markets.
- How the issue in question fits in with any upcoming regulatory developments/ongoing activity at a domestic, EU or wider international level.
- Whether the market has been (or is likely to be) subject to significant non-regulatory change that has not had sufficient time to bed in, but might have an important impact on the relevant issues.
- How a market study would affect the FCA's current portfolio of work.
- Whether the issue might be better addressed by another form of FCA intervention (such as enforcement or supervisory action), or by another authority.
- The likelihood of a successful outcome.

1.18 We have also considered relevant work that the FCA has already carried out.

3 Pages 12-13, *Wholesale sector competition review, call for inputs*: www.fca.org.uk/your-fca/documents/market-studies/wholesale-sector-competition-review--call-for-inputs

Market study on investment and corporate banking

1.19 Based on our analysis of the issues raised against our prioritisation criteria, we have selected the topic of investment banking and corporate banking services for our first wholesale market study. Within this market study, we will focus on the impact of transparency and bundling on competition for investment banking and corporate banking services.

1.20 This is an appropriate market study because the benefit from improvements in the way competition works could be high. This is partly due to the size of the market, but also due to the reach and impact of the role of these entities and services they offer within the wider economy.

1.21 We also considered our ability to intervene effectively at a UK level. We consider that many of these services are global in nature, but many of the issues raised in this document could be usefully considered at a national level. Furthermore, some of the issues are unique to the structure of the UK market.

1.22 The competition issues in investment and corporate banking services which were identified as part of this review have not previously been the subject of FCA investigation.

1.23 We also consider that a market study into asset management and related services would be appropriate in the future. This would focus on how purchasers get value for money when buying asset management and related services. However, the FCA and others have recently conducted a number of related pieces of work in asset management, the results of which may affect the competition issues which we have identified. We therefore anticipate conducting a market study on asset management and related services at a later date, once the implications of other policy work are clear.

1.24 Chapters 2-5 set out in more detail our assessment of the other issues raised by respondents following the release of our call for inputs. Within these sections, we identify some areas where there are strong suggestions that competition is not working effectively. However, in some instances, forthcoming legislation may change the market significantly or address some of the issues identified. Where this is the case, we may conduct a market study in these areas, if the evidence suggests that problems still remain.

1.25 Undertaking a market study does not preclude us from undertaking other work (for example supervisory work or investigating an issue with our Competition Act powers, when these become available in April 2015). And if the Fair and Effective Markets Review consultation identifies any competition issues within FICC markets, we may consider further investigation of these issues.[4]

4 See: www.bankofengland.co.uk/markets/Pages/fmreview.aspx

What is a market study?

Market studies are a key way in which we investigate markets to see how well they are working for consumers. They are in line with our competition, consumer protection and market integrity objectives.

We currently undertake market studies when we have identified that there are potential competition issues in a market. We do not need to have found definitive evidence of such issues. Instead, we would look to undertake further work into understanding and identifying competition issues and the impact that they have on a market.

We identify markets where competition may not be working effectively using information from a range of sources, such as our own intelligence, past studies, internal papers and analysis, market intelligence and supervision activities of regulated firms. Before launching a market study we consider the issues that concern us and develop our views on the reasons that competition may not be working in the interests of consumers.

Generally, we launch market studies with the publication of terms of reference which set out the scope of the study and the possible causes of concern.

We gather information about the market to see how well it is working for consumers. We use the data we collect to assess evidence of competition issues or other market failures and assess the extent of any consumer detriment. We do this by considering the evidence and views we receive with reference to the issues identified and the theories we are testing.

When assessing competition, we consider all of the features of the market, including the competitive constraints that suppliers face from current rivals, the ability of new suppliers to enter the market (and how this entry might be constrained by costs, applicable regulation and other factors), and the ability of consumers to obtain, assess and act on information relevant to their purchasing decisions.

If we conclude that competition is not working well we have a number of tools at our disposal to propose and/or implement remedies. More information about market studies can be found on our website: **http://fca.org.uk/your-fca/documents/market-studies/how-we-carry-out-market-studies**

2.
Market study on investment and corporate banking

2015 Market study on investment and corporate banking

- We will undertake a market study into investment and corporate banking to identify whether competition is working effectively.
- This is because external feedback and our own analysis suggests that competition is not working effectively in this sector. In particular:
  - Limited transparency over both price and quality may make it difficult for clients to assess value for money;
  - Bundling and cross-selling of services may make it difficult for new entrants to compete and may contribute to low levels of transparency.
- We will launch the market study and publish the terms of reference for this study in spring 2015 which will set out the scope in more detail.

Overview

2.1 Investment and corporate banks offer their clients a range of services which enable them to raise capital for investment, expansion or funding ongoing operations. These services include lending, advice and facilitation of an initial public offering, subsequent debt and equity capital raising, and advice on and financing of mergers and acquisitions (M&A).

2.2 Investment banks provide institutional investors with a number of investment services and services related to their corporate client base including making markets[5] for a corporate client's securities, providing trade execution services[6] and offering investment research. Investment banks also arrange roadshows where management of the bank's corporate clients meets with the bank's investor clients. These services can influence liquidity of the corporate client's shares and debt securities and its cost of equity and debt capital.

5 A market maker quotes two prices for a security, the price at which they are willing to buy (the bid price) and the price at which they are willing to sell (the ask or offer price). Market makers profit from the difference, or the 'spread', between the bid and ask price.

6 When a client wishes to buy or sell a security, they place the order with a broker, which may be an investment bank. The broker then transmits the order to the market to be filled. The provision of this is known as trade execution services.

2.3 The cost and quality of services provided by investment and corporate banks play a vital role in supporting the wider economy. If corporate clients requiring investment or corporate banking services fail to raise necessary capital or the client pays more for the financing than it should, it could have a significant impact on their ability to operate or undertake necessary investments. Furthermore, if the costs of providing the advice or the costs of acquiring services from investment banks are too high, this could lead to higher prices for end-consumers. Therefore, it is important that effective competition in these markets exists to ensure that clients have, among other things, access to the desired quality of service/advice at the right price.

2.4 Concentration can be a high-level indicator of the level of competition in a given sector. Market participants offering investment banking services include universal banks (which offer a wide range of investment banking services, plus other services, such as corporate banking) and 'boutique' banks and service providers who compete with the larger investment banks in some segments, such as advisory services. The level of concentration in the markets in which investment banks are active appears to be typically moderate, with 10-15 participants active in the provision of many of the services identified. For example, in the UK during 2014, the top 15 banks accounted for around 81% market share in Debt Capital Markets (DCM) and in Equity Capital Markets (ECM).[7]

2.5 However, the relationship between concentration and the effectiveness of competition is not straightforward. For example, Liu and Ritter (2011)[8] argue that the underwriting industry can be described as a series of local oligopolies, based on various non-price dimensions of underwriting such as all-star analyst coverage, industry expertise, and top-tier underwriter status. Furthermore, concentration in some segments may be higher than for investment banking services in general, where firms need significant specialist expertise or capital to compete effectively.

2.6 Concentration is just one indicator of the way competition works in a given sector. Despite the moderate levels of concentration for some investment banking and corporate banking services, other indications suggest that competition may not be working effectively for these services. These include the following issues which are discussed in more detail throughout this section:

- Low levels of transparency - In general, value for money for investment and corporate banking services may be difficult for clients to assess, with both quality and costs often difficult to predict in advance. While corporate clients are generally more sophisticated than retail customers, a lack of transparency of expected quality and the costs of service at the point of purchase may prevent competition from working effectively in the market.

- Bundling and cross-selling of services - Investment and corporate banking services often benefit from economies of scope, whereby the cost of providing additional services for an existing client are likely to be lower than the stand-alone cost of providing these services. This is because the provider of the services has already invested in the client relationship, and in understanding the client's business model. This can be beneficial for the client, who may value having advisers who understand the needs of the business. However, where bundling occurs, it may be more difficult for clients to assess whether they are getting value for money when paying for a series of services over time. This is because the client may not

7 Market shares calculated from Dealogic data. The ECM market shares are from the IPO rankings on UK exchanges by bookrunner based on the deal value apportioned to that bookrunner. The DCM market shares are from the DCM rankings of deal value apportioned to that bookrunner for UK deals whereby the issuer is based in the UK. In this context, DCM includes the following categories: corporate bonds (both investment grade and high-yield), preferred shares, asset backed securities, mortgage backed securities, sovereign/local authority bonds, supranational bonds, US agency bonds, non-US agency bonds, medium-term notes.

8 Liu, X., and Ritter, J. R., 2011, Local underwriter oligopolies and IPO underpricing, *Journal of Financial Economics*, 102(3), pp.579-601

understand the relative price of the different services. In addition, bundling and cross-selling may act as a barrier to entry and expansion where competitors must offer the whole bundle of services to compete.

- Principal-agent issues - In some circumstances, an investment bank acts as an agent for a client, transacting on their behalf. Where this is the case, it may be difficult for clients to monitor whether the service that they are getting is of the right quality (for example, where a client would need a significant amount of data to evaluate the service given, it may be costly, time consuming or complex). If the incentives of the principal (the client) and the agent (the provider of investment banking services) are not aligned, and the principal is not able to monitor the actions of the agent sufficiently,[9] there is a risk that the bank will not act in the best interests of the client.[10]

Responses to the call for inputs on investment and corporate banking

2.7 The responses we received to the call for inputs raised issues about the supply of both investment banking and corporate banking services and the possible effects that sales practices have on competition, with a particular focus on:

- Bundling of investment banking and corporate banking services;
- Fees and conflicts of interest in the market for debt and equity issuance;
- Barriers to entry in the corporate banking market; and
- Best execution and the FCA's recent thematic review.

Bundling

2.8 Several respondents noted that investment banks bundle some services with other investment banking/corporate banking services and commented on how such practices may affect competition. Bundling can take a number of forms:

- Pure bundling: two or more services are sold as part of a package and these services are not available separately;
- Mixed bundling: two or more services are sold together in a package, although each service can be purchased separately. However, if a consumer were to purchase each individual service separately, the overall price would exceed that of the bundle. Therefore, the consumer is incentivised to buy the bundle; and
- Tying: a special case of mixed bundling. It occurs when two or more services are sold together in a package, but at least one of these services is not sold separately. The tie can be either explicit, through legally binding contracts, or implicit;

9 For example assessing whether the service provider is acting in their best interests, and switching to another provider where this is not the case. Monitoring the agent may be difficult or time consuming for the principal to undertake and switching may be difficult particularly where the client wants to minimise the number of parties who are informed of confidential information.

10 See Mehran and Stulz (2007) for an overview of the literature on conflicts of interest. Mehran, Hamid & Stulz, Rene M., 2007. "The economics of conflicts of interest in financial institutions," Journal of Financial Economics, Elsevier, vol. 85(2), pages 267-296, August.

- Cross-selling: the practice of a repeat sale of similar or different services by the same multi-product provider to an existing customer, either contemporaneously or over several periods of time.

Responses to our call for inputs on bundling

- Some independent service providers and representatives of wholesale customers' interests argued that bundling of services makes it difficult for independent providers to enter the market and reduces incentives to innovate in some sectors.
- Some respondents commented that sponsor services,[11] corporate broking and research are examples of services where quality may be low, but they are frequently provided for free or at a price that is below the cost of providing the service on a standalone basis, which may deter potential competitors from entering the market.
- Some independent service providers noted that investment banks provide lending on un-economic terms and require that clients take additional services (or that clients' feel obliged to take these services).
- A number of respondents, most notably large universal banks, argued that there is strong competition between providers of bundled and unbundled services.
- Several of the respondents noted that fees in equity and debt capital markets (ECM and DCM respectively) have been falling or are under pressure and that providers of unbundled services have successfully entered the market, noting for example the number of boutique advisory firms offering specific non-bundled services.
- Respondents noted that corporate clients, especially large ones, typically work with a number of investment banks. On the other hand, it was suggested that smaller corporate clients typically have an exclusive banking relationship with one bank.
- Some respondents, mostly representing wholesale purchasers' interests, noted that it is difficult for corporate clients to understand the pricing of services that are bundled or cross-sold.
- However, one investment bank suggested that fees are transparent to the clients.
- A large corporate client suggested that many corporate clients may not be able to adequately assess the quality of the follow-on investment banking services in both debt and equity markets.
- An institutional stockbroking firm, who also provides corporate finance advisory services, argued that competition is working well in corporate advice and underwriting and emphasized the value of long-term relationships between corporates and investment banks, especially for mid-sized corporate clients and their corporate brokers.
- An investor trade body recognised the benefits of long-standing relationships. However, they are concerned that these arrangements may affect the ability of corporate clients to negotiate on fees.

11 The FCA requires premium listed companies (issuers) to appoint sponsors on major transactions. Sponsors provide expert guidance and carry out independent checks to ensure issuers comply with key parts of the FCA's listing rules. AIM listed companies appoint NOMADs (nominated advisors)

Bundling: our analysis

2.9 Evidence from past studies by regulatory authorities and academic researchers on the effect of bundling, tying and cross-selling of goods and services more generally (i.e. beyond investment banking services) is mixed.[12] In most cases, providers bundle products and services for efficiency reasons. Buying a set of services from the same provider over time may also be an efficient solution for the customers, e.g. because firms do not need to invest in several relationships.[13]

2.10 There may also be detrimental effects for some clients. Most notably, bundling could be used by a firm with significant market power in one aspect of the bundle to exclude competitors and thereby decrease the intensity of competition. For example, where below market price lending is provided on the assumption that the firm receiving the lending will purchase additional, more profitable services over time, this can reduce the intensity of competition for the additional services.

2.11 Bundling may also distort the market for the service being provided below cost. This may mean alternative service providers cannot compete with existing providers as they are not able to offer services at below market value (for example where they are stand-alone providers of services who cannot cross-subsidise). This may reduce innovation and lead to reduced quality in the services provided for free/below cost. For example, where corporate broking is provided for free it is likely to be difficult for new entrants, who cannot subsidise the costs of corporate broking services, to compete effectively.

2.12 Detailed knowledge of a client may enable the bank to provide a range of services more efficiently than a number of banks who would all need to invest in building up this knowledge base. In addition, it is likely to be hard for competitors to generate high quality bespoke ideas to win new clients, whereas an investment bank with detailed knowledge of the client's business can use this to pitch for further work. Clients may value these long-term relationships and may benefit from bundling. As a result, client relationships are important when competing for the provision of investment banking services.

2.13 Competition for new customers can be effective, with many alternative options existing for an initial service to a customer. However, once the customer is in a relationship with an investment or corporate bank, the customer may perceive they have fewer potential providers to choose from when purchasing certain services. This may be because they perceive that it is difficult or costly to switch to or purchase additional services from rival banks. We note, however, that large corporate clients are likely to have relationships with more than one bank and so this effect may be less pronounced for them.

2.14 When establishing a relationship with an investment bank, clients will often undertake a tendering process to compare different providers of the services they require. Where a client is uncertain about the range of services it will need in the future, it may find it much more difficult to estimate value for money from different providers. The investment banks are able to offer new or different services as their clients' requirements change. During the initial tendering

12 For an overview see for example Section 7.3.2. of Motta, M., 2004, *Competition Policy: Theory and Practice*, New York: Cambridge University Press. For an overview of the effects of banking relationships see Degryse and Ongena (2008) or Bharat et al. (2007) Bharath, Sreedhar, et al. "*So what do I get? The bank's view of lending relationships.*" Journal of financial Economics 85.2 (2007): 368-419.
Degryse, Hans, and Steven Ongena. "*Competition and regulation in the banking sector: a review of the empirical evidence on the sources of bank rents.*" Handbook of financial intermediation and banking 2008 (2008): 483-554.

13 A survey of 48 companies by (Office of Fair Trading, 2011) revealed several reasons why companies change their corporate brokers relatively infrequently. Fourteen said that establishing new relationships with corporate brokers made switching difficult. Thirteen said the signal that it sent to the stock market about their company made switching difficult. Four respondents said that identifying suitable alternative providers made switching difficult.

process the investment banks may be better able to estimate the future service requirements due to their previous experience. This can lead to an asymmetry of information between the client and the bank. The client's inability to accurately assess requirements, their inertia or a lack of re-tendering for services may result in them being unable to achieve value for money. Conversely, where a customer can accurately estimate the range of banking services it will require over time and has sufficient bargaining power, it may be able to tender and effectively compare different providers of these services and receive a good quality of service.

2.15 A lack of transparency may arise from firms bundling or tying services together over time, especially when some services are explicitly charged for and others are not. This is because the client is unlikely to know exactly what they are paying for when purchasing a bundle of services or may be unable to estimate the stand-alone cost of the products and services provided. The client would then be unable to evaluate whether the cost is appropriate for the level of service provided. Where this is the case, the client is likely to be less able to negotiate a better deal, or switch to an alternative provider if the provider is not offering value for money.

2.16 For example, an investment bank effectively seeks to bundle when it offers corporate broking services for free (or at low cost) in anticipation of the corporate client purchasing ECM services in future. The client may find it difficult to evaluate the value for money of corporate broking services and subsequent ECM services, as they may not be able to assess the stand-alone cost of the services. Such practices may be detrimental to the corporate client since they may be able to purchase ECM services from a rival bank at a lower cost and/or better quality.

2.17 Larger firms may be able to buy services unbundled, as they have greater power in negotiations due to the size of transactions they undertake (or may undertake in the future). As noted by respondents to our call for inputs, smaller corporate clients may have an exclusive banking-brokerage relationship with one provider. This may affect their ability to compare providers or switch to alternative providers, which may amplify the competition issues identified with bundling.

Responses to our call for inputs on equity and debt issuance

- We received responses on the markets for equity and debt capital issuance. Respondents commented on the overall fees charged by investment banks for equity issuance and the potential conflicts of interest in the allocation of equity in the initial public offering (IPO) process.
- A large investment bank and a trade body suggested that competition for debt underwriting activities is effective. Participants in the investment banking roundtable event stated that large corporate clients have relationships with several banks and rotate the lead firm in separate DCM transactions. The participants suggested that this incentivises banks to provide a good service and promotes competition. One respondent said that prices cannot fall much further before the activity becomes unprofitable.
- Some respondents argued that examining ECM activities should not be a priority for the FCA following the recent OFT report into underwriting fees.[14] One respondent believed that companies should take greater responsibility for negotiating keener pricing of fees when purchasing equity issuance services. However, another suggested that despite the recent OFT report, the level of fees is still excessive and a result of a lack of competition in the market.
- A trade body said that deep discounts in rights issues should be encouraged as it decreases the risk of an unsuccessful issuance, which in turn should reduce issuance fees.
- The trade body also advocated the unbundling and disclosure of overall issuance fees, believing this will allow issuers to negotiate more effectively on individual services provided during the issuance (e.g. primary underwriting, sub-underwriting, advice, preparation, documentation and other rights issues related services). However, they did not consider tendering of both primary and sub-underwriting necessary and said it should only be pursued if unbundled fees fail to reduce overall fee levels.
- Some respondents commented on the potential conflicts of interest between investment banks responsible for allocating shares in an IPO and the issuing firm. For example, one respondent suggested that large investment banks favour their prime brokerage and hedge fund clients when allocating the shares in an IPO, which may not be in the interests of the issuer. Another respondent noted that these conflicts are being dealt with in MiFID II.[15]
- A couple of respondents commented on the trend to include an increasing number of banks in the syndicate managing an IPO. They argued that this practice militates against an individual syndicate member having an unfair influence over the final allocations. Furthermore, the respondents argued that issuers have had a greater influence over the management of the IPO process since the proposals of the OFT report have been implemented. However, the ABI, in a July 2013 paper entitled 'encouraging equity investment' noted that when there are a lot of banks on the syndicate this may limit the independent research available by conflicting a large number of respected analysts, which can stifle a more balanced view of the transaction.

14 OFT (2011), *Equity underwriting and associated services: An OFT market study*, http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/shared_oft/market-studies/OFT1303.pdf

15 In ESMA's technical advice to the European Commission on delegated acts under MiFID II and MiFIR, they advised the Commission to place specific requirements on firms to manage conflicts of interest in underwriting and placing. See section 2.10 of: ESMA, 2014, *ESMA's technical advice to the Commission on MiFID II and MiFIR Final Report*, www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf.

Equity and debt issuance: our analysis

2.18 We note that investment banks frequently bundle services together when selling capital markets services. Investment banks typically charge a single fee for issuing a corporate client's equity or debt. However, within this fee, charges for several services are bundled together such as primary underwriting fees, sub-underwriting fees, advisory fees, and document preparation fees. As discussed above, bundling may affect the issuers' ability to negotiate effectively on fees or to assess value for money.

2.19 It is possible that issuing companies have limited control over who invests in their company when new securities are issued and placed on the primary market by the investment banks managing the issuance. It is possible that investment banks may have incentives to allocate shares to investors in a way that would not be optimal for the issuer, without the issuer fully realising it (for example to reward institutional investors for their business).

2.20 Typically the lead bookrunner determines who is allowed to buy shares and how much of their order is filled. In a 2007 survey of European investment firms, it was found that the broking relationship with the bookrunner is perceived to be the most important factor influencing share allocations (Jenkinson & Jones, 2007).[16] Research by Jenkinson and Jones (2004)[17] suggests that the more IPOs that an investor participates in with a particular investment bank, the more likely they are to receive future allocations.

2.21 There is evidence to suggest that, in the US, lead underwriters allocated shares of underpriced IPOs to mutual funds from which they receive large brokerage commissions (Reuter, 2006).[18] These concerns may also be relevant in the UK. Where investment banks have incentives to allocate equity and/or debt to institutional clients based on commissions received, the allocation given may not be in the issuing client's interest. Where the client has the ability to monitor and dictate the allocations given, this risk would be mitigated. However, where clients are not able to assess whether the allocations meet their wishes, they will not be able to challenge the investment bank to ensure that allocations are in their interests. For example, an issuer may value having long term investors, whereas the investment bank may have an incentive to allocate shares to institutional investors who trade with them a lot, but are more likely to sell the shares shortly after they receive the allocation.

2.22 Investment banks have been given significant control during the allocation stage. They provide a service to issuers by using their existing relationships with investors to generate interest in the issuer's equity. This saves the issuer from having to build relationships with investors themselves, which is potentially costly.

2.23 The OFT's 2011 report, 'Equity underwriting and associated services', noted there had been a significant increase in fees since the onset of the financial crisis. Average fees rose to more than 3% in 2009 from around 2 to 2.5% in the period from 2003 to 2007. In the same period, average discounts on rights issues rose to nearly 40% from around 30%. It noted that, while such increases could be explained, at least in part, by the increase in volatility and risk in this period, analysis suggested that fees and discounts had been slow to fall in line with subsequent reductions in risk, in particular from lower stock market volatility.

16 Jenkinson, T. and Jones, H., 2007, IPO pricing and allocation: a survey of the views of institutional investors, *The Review of Financial Studies*, 22(4), pp.2055-2082.

17 Jenkinson, T. and Jones, H., 2004, Bids and allocations in European IPO bookbuilding, *Journal of Finance*, 59(5), pp.2309-2338.

18 Reuter, J., 2006, Are IPO allocations for sale? Evidence from mutual funds, *Journal of Finance*, 61(5), pp.2289-2324.

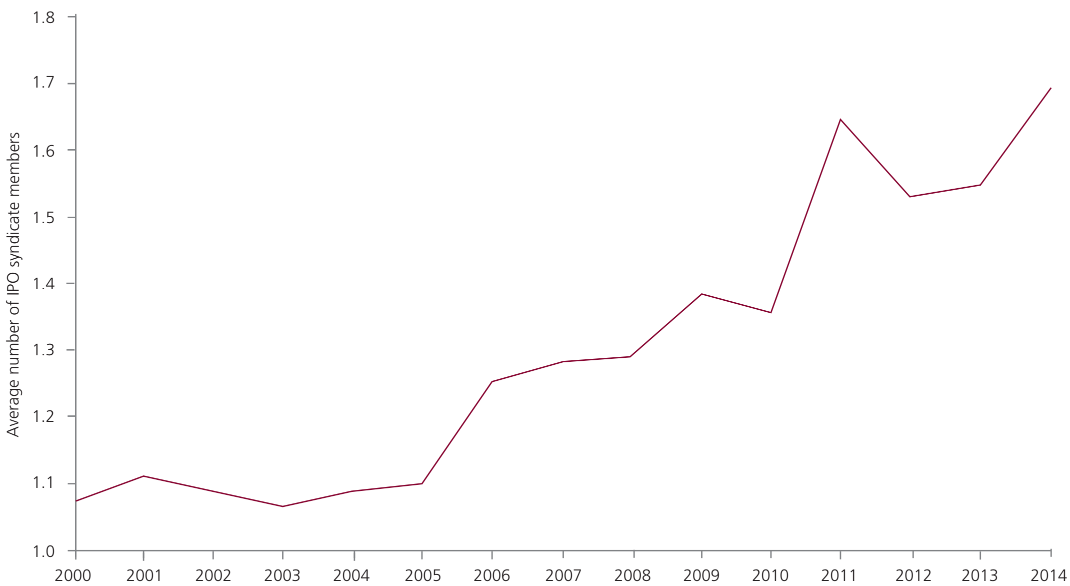
2.24 This analysis suggested that the trends towards higher fees and discounts, and greater clustering of fees and discounts, may be the result of companies not negotiating cost effective outcomes with shareholders and not putting sufficient pressure on companies raising equity capital to reduce costs. The analysis found that companies, albeit sophisticated purchasers of services generally, typically lack regular, repeated experience of equity-raising and are not focused principally on the price they are paying for equity underwriting services when they issue shares.

2.25 The OFT provided some advice to corporate clients who were considering an equity issuance in order to improve the competitive tension between investment banks pitching for ECM services. Recommending that corporate clients should:

- Request a breakdown of the underwriter's proposed fees into constituent components. This could allow corporate clients to apply downward pressure on fees on each element of the total underwriting fee;
- Invite the investment banks with which the corporate already has an existing relationship, including corporate brokers and lenders, to compete with each other for certain elements of the underwriting work; and
- Increase the number of banks that the corporate has a relationship with.

2.26 The OFT also found that the average number of banks involved in an underwriting syndicate increased significantly during the financial crisis and recession. This may have been due to the historically high levels of equity capital being raised, and the scale of the transactions, during the financial crisis and recession, which meant that investment banks sought to share the risk to a greater extent than before. This trend for larger underwriting syndicates has continued following the OFT's report (see **Figure 2**).

Figure 2: The average number of banks in IPO syndicates has been increasing over time



Source: Calculated from Dealogic data. Based on all IPOs on UK exchanges between 2000 and 2014

2.27 An increase in the number of banks involved in a syndicate may enable the issuer to reach a wider range of potential investors. In addition, inviting more co-managers may increase competition for the lead underwriter position as the co-managers become competitors for future issuance (e.g. seasoned equity offerings).[19] However, as noted by the ABI,[20] larger syndicates may result in an inefficient bookbuilding and allocation process, lower net fees for banks which may not motivate some banks to work in the clients' interests and some banks adding no value to the process.

2.28 The effect which syndication has on competition depends on how the syndication process takes place. We understand that the way that syndication works for equity and debt issuance differs from the syndication process for loans, and consider that syndication may be an area which would benefit from further investigation.

Responses to our call for inputs on corporate banking

- An investment bank commented that there are barriers to entry into the corporate banking market. However, the respondent also indicated that the market for corporate banking services to large firms is significantly less concentrated than that for small and medium enterprise (SME) banking and that large corporate clients have far more complex needs than SMEs. Larger corporate clients typically have ongoing relationships with several banks, making it easier to have a competitive process for corporate banking services provision. In the roundtable discussions it was suggested that switching may be difficult for non-financial reasons such as risk and due to the fact that it is resource intensive and time consuming.

- Another investment bank noted that recent reforms by the FCA and the PRA in relation to registration and capital ratio standards are reducing perceived barriers.[21]

- One respondent argued that large corporate clients (with an annual revenue of £25m or more) are sophisticated, so the potential issues highlighted in the CMA and FCA's market study on SME banking[22] were not relevant in the context of these large corporate clients. They pointed out that these large companies often have dedicated finance divisions which are tasked with ensuring that the firm receives a competitive service offering.

- A respondent referenced a report demonstrating that customer satisfaction levels for corporate banking services among large corporate clients are high. An investment bank suggested we should not look at corporate banking until the CMA and FCA reach their provisional findings in September 2015.

19 Corwin & Schultz (2005)

20 Encouraging Equity Investment, July 2013

21 See Bank of England and FSA (2013), *A review of requirements for firms entering into or expanding in the banking sector*, www.fca.org.uk/your-fca/documents/barriers-to-entry

22 FCA and CMA (2014), Banking services to small and medium-sized enterprises, www.fca.org.uk/news/market-studies/joint-fcacma-sme-banking-market-study

Corporate banking: our analysis

2.29 Significant capital is required to set up a corporate banking business and this may make it difficult for new entrants to enter the market.

2.30 However, we note that the Bank of England and FSA revisions to the application process for new entrants to the SME banking space is expected to make entry easier.[23] The three main changes made under the reforms were:

- Lower capital requirements at authorisation – Start-ups now only require 4.5% minimum Core Tier 1 capital versus 7% to 9% for incumbent banks;
- Removal of additional requirements for start-up banks - The increased uncertainty associated with start-ups meant they often required higher capital or liquidity than incumbents. Such requirements have been removed; and
- A changed authorisation process to ease business start-up - Greater transparency was introduced to help speed-up the authorisation process.

2.31 In the 12 months following these changes, we saw a substantial increase in the number of firms discussing the possibility of becoming a bank. During that time, with the PRA, we approved five new banks, held discussions with 25 potential applicants, and greatly increased the amount of support we offer to applicants.[24] However, the operational barriers to entry are likely to still exist which make it difficult for new entrants to compete for larger corporate clients, for example where larger clients expect their corporate bank to offer complex currency facilities and/or operate in multiple jurisdictions.

2.32 There are still substantial barriers to entry in the banking industry. Factors such as reputation, operational requirements, and access to payment systems may still deter firms from entering the market. The Independent Commission on Banking noted that competition in this industry is not purely based on price, but also on non-price factors such as reputation and established relationships.[25]

2.33 As set out in the call for inputs, corporate banking provides universal banks with an additional source of information, (for example, on primary market activities such as corporate finance) and therefore the ability to cross-sell products and services to their clients. Establishing a relationship through the provision of corporate banking services, for example lending or transaction services, may enable universal banks to cross-sell underwriting services or advice on mergers and acquisitions. The potential competition issues, and potential benefits associated with bundling and cross-selling in investment banking above apply equally to cross-selling within corporate banking, and between corporate and investment banking services.

23 See Bank of England and FSA (2013), *A review of requirements for firms entering into or expanding in the banking sector*, www.fca.org.uk/your-fca/documents/barriers-to-entry

24 Bank of England and FCA (2014), *a review of requirements for firms entering into or expanding in the banking sector: one year on*, www.fca.org.uk/static/documents/barriers-to-entry-review-one-year-on.pdf [Accessed 8th January 2015].

25 Independent Commission on Banking, 2011, *Interim report consultation on reform options*, http://webarchive.nationalarchives.gov.uk/20121204124254/http:/www.hm-treasury.gov.uk/d/icb_interim_report_full_document.pdf

Best execution:

2.34 The best execution obligation requires investment firms to take all reasonable steps to obtain the best possible result when executing orders on behalf of retail and professional clients, taking into account the execution factors – price, costs, speed, likelihood of execution and settlement, size and nature of the order, or any other consideration relevant to the execution of the order.[26] In doing this:

- Firms must establish and implement effective arrangements for complying with the best execution obligation, including an order execution policy that describes how these arrangements will operate.
- Firms must monitor the effectiveness of their arrangements and execution policy, as well as be able to demonstrate to clients that they have acted in accordance with that policy.
- Firms' senior management also need to use the results of their robust monitoring and substantive review of their execution arrangements, including taking corrective action where required, to enable them to demonstrate to clients that they are delivering best execution consistently.

Responses to our call for inputs on best execution

- A few respondents argued that the FCA should allow time for the industry to respond to the FCA's recent thematic review[27] into best execution and await the introduction of new rules under MiFID II before looking at this area. One respondent said that best execution should be dealt with under the FCA's supervision and not competition function, because it is a regulatory obligation.
- One respondent argued that firms' delivery of best execution could be distorted by payment for order flow or by the trading venue fees and incentives offered. Many respondents agreed that best execution is more difficult to monitor with less liquid assets; especially given the need to take account of non-price factors.
- A large investment bank argued that firms compete with each other in a number of different ways. For example, they suggested that smaller brokers may find price to be an important factor while larger brokers may compete on a range of quality factors. Clients then choose a broker depending on the factors most important to them. Another respondent noted that brokers compete with exchanges in the market for client order flow, for example by providing dark pools to rival lit exchanges.[28]

26 CESR, 2008, MiFID supervisory briefings – best execution,: www.esma.europa.eu/system/files/08_735.pdf

27 FCA (2014), Thematic review into best execution and payment for order flow, www.fca.org.uk/news/tr14-13-best-execution-and-payment-for-order-flow

28 Dark pools are arrangements for trading financial instruments, organised by operators of trading venues or brokers, in which indications of trading interest are not made available to participants or the wider market. Lit exchanges are segments of conventional regulated trading venues where bid-ask spreads and the depth of trading interests at those prices are publically displayed.

Best execution: our analysis

2.35 Best execution is a regulatory requirement.[29] However, even with best execution rules in place, brokers may still execute orders to maximise their gains, rather than act in the interests of their clients because:

- Achieving high levels of execution quality is costly. For example, brokers need access to multiple trading platforms or costly IT infrastructure;

- Orders that are not executed at the best possible price are valuable to brokers. This is because they could get a better price from a dealer or market maker and profit from the difference between purchase and sale price (this is known as making a profit on the margin). Therefore, brokers could demand inducements (financial or non-financial) from dealers and market makers for their client order flow. In the case of vertically integrated broker-dealers, these profits could be retained as the order can be internalised.[30] The ability for firms to accept third party payments is governed by the inducements rule in the FCA handbook.[31]

- Clients may face difficulties in monitoring best execution from their broker. Brokers therefore may not be competing with their rivals on the basis of execution quality.

2.36 The FCA's recent thematic review into best execution and payment for order flow[32] found examples where this was the case and we note that this may have implications on the way in which competition works.

2.37 The thematic review found that:

- **Scope** – investment firms had a poor understanding of which activities are covered by the best execution obligation and frequent attempts were made by firms to limit the scope of the obligation.

- **Monitoring** – most firms lacked effective monitoring capability to identify best execution failures or poor client outcomes.

- **Internalisation and connected parties** – firms who frequently internalised orders or sent them to connected parties were often unable to evidence whether this provided best execution and how potential conflicts of interest were managed.

- **Accountability** – it was often unclear who had responsibility and ultimate accountability for ensuring that execution arrangements and policies met the best execution obligation.

29 MiFID II introduces several changes for investment firms executing client orders. The execution policy must be provided in sufficient detail and in clear, easy to understand language. Investment firms must summarise and make public, for each class of financial instrument, the top five execution venues where they executed client orders in the preceding year and provide information on execution policy. Firms should not receive any remuneration for routing clients' orders to a particular trading or execution venue if this is not compliant with conflicts of interest and inducements rules. See: www.esma.europa.eu/page/MiFID-II-application

30 Internalisation occurs when a broker-dealer executes an order against its own book. That is, it is able to match client buy and sell orders internally without having to send them to the open market.

31 See COBS 2.3 for guidance on inducements, and specifically the rule on inducements is COBS 2.3.1R. FCA Handbook is available at: http://fshandbook.info/FS/html/FCA

32 FCA (2014), Thematic review into best execution and payment for order flow, www.fca.org.uk/news/tr14-13-best-execution-and-payment-for-order-flow

2.38 The report suggested that most brokers place the emphasis of monitoring best execution on the buy-side client, i.e. investors. These firms presumed that clients would simply switch provider if they felt they were not being given best execution. However, most firms in the sample were overly reliant on this presumption and were not adequately fulfilling all of the best execution requirements.[33]

2.39 The FCA also found that a few firms active in exchange traded derivatives were accepting payments for order flow. Our thematic review into best execution and payment for order flow stated that such arrangements create a clear conflict of interest between the firm and its clients, are unlikely to be compatible with our inducements rule and risk compromising best execution.

Market study suitability

2.40 Following the responses we received to the call for inputs and our broader considerations, our preliminary analysis suggests there may be areas of corporate and investment banking where competition is not working effectively. The competition issues which would benefit from further investigation include:

- Transparency of investment banking and corporate banking services, and the ability of clients to assess effectively whether they are getting value for money (including the ability to monitor whether they are getting best execution and the ability of issuing clients to monitor the allocations being provided and ensure that the allocations are consistent with their wishes); and
- The cross-selling, bundling and tying of investment banking and corporate banking services – including the impact this has on transparency and the ability of competitors to enter the market or expand.

2.41 Our reasons for considering a market study into investment and corporate banking to be a priority are:

- Poor disclosure of the costs of the different components of a bundle, together with weak bargaining power or weak monitoring incentives of clients may lead to detriment. While it may appear that firms actively compete to win business from the client, customers may not always be able to judge the quality and the price of services correctly in advance or may have weak bargaining power to negotiate them upfront. These customers could face high switching costs later, for example where the client wants to limit the number of market participants who are aware of market sensitive data, and could get locked-in, leading to higher prices. For example, investment banks can compete on the prices for an initial service to a customer, such as corporate brokerage, but once the customer is locked-in (if switching costs are perceived to be high), excess profits can be made on further services sold to the customer.

33 The findings of the thematic review are backed up by some evidence in the academic literature. For example Gomber et al (2012) compare best execution policies for 75 investment firms in Germany at two points in time (2008 Q2 and 2009 Q3). MiFID stipulates that firms must review their best execution policies on an annual basis or whenever a major change occurs. The authors found that in most cases, firms did not substantially update their policies, thus not reflecting the changing market shares of the different venues available.

- The characteristics of the corporate client may also affect the price and quality of service they receive. Larger corporate clients may have greater bargaining power than smaller corporate clients and thus be able to negotiate better deals. Similarly, frequent purchasers of investment and corporate banking services may be able to negotiate more effectively and receive a better quality of service as they have more experience. Conversely, new issuers or smaller clients with less bargaining power may find it more difficult to negotiate effectively.

- Cross-selling, bundling, and tying affect the way competition works in the markets for different investment and corporate banking services and we understand from the responses that there could be detrimental effects for some corporate clients. There may also be strong efficiency reasons for this practice. A market study could explore further the actual effects of the practice in these markets.

- The syndication process may affect the way competition works for a service either positively or negatively. We note that the syndication process, and therefore the way that competition works, for issuance and lending differ substantially and this is something that we could consider further as part of a market study.

- We are aware that potential conflicts of interest could arise in share allocations during IPOs (or when issuing debt), which could result in investment banks favouring their prime brokerage or hedge fund clients as well as their own asset management businesses when allocating shares. For example, the issuing clients may want investors who are likely to have a long term holding whereas the investment bank may be incentivised to allocate to clients that generate the most short term flows or commissions such as hedge fund clients. Where the issuing client is not able to effectively monitor the allocation process, and to ensure that the allocations given are consistent with their best interests, the final allocation may not be in the issuing client's best interests.

- Revenues received from investment banking and corporate banking services, provided to corporate clients in the UK, in 2013 totalled £10bn.[34] This does not include services provided to the corporate clients based outside of the UK nor to institutional clients. We therefore consider that the potential scale of benefits from improvements in the way competition works could be high. This is particularly relevant given the integral role that investment banks play within the wider economy.

- If a client overpays for the investment banking or corporate banking services it buys, this could impact investment decisions and ultimately be passed on to retail customers. In addition, if the quality of service provided to the firm is below the required quality, for example if advice given is inadequate, the firm may pay too much for a target company, or the share price of an IPO may be set at the wrong level.

34 This is an internal FCA estimate. The activities included in the sum include the services: ECM, DCM, M&A advisory, transaction financing, treasury, cash custody, loans, asset-backed finance and structured finance.

- We do not expect forthcoming regulatory developments, including changes arising from MiFID II[35], to undermine the case for a market study in this area. Where regulatory change does affect any competition issues that we have identified we will take this into consideration.
- The market study would focus primarily on activities that are within our regulatory perimeter, such as investment banking activities including underwriting i.e. the arranging, buying and placing of the securities. The scope of the market study may include activities that are outside our regulatory perimeter where these activities affect the functioning of the market in question, in particular the provision of corporate lending.
- We do not consider that the investment banking and corporate banking sector is subject to major non-regulatory change that would make it unsuitable to undertake a market study in this area.
- Many investment and corporate banking services are global in nature, but many of the issues raised in the call for inputs could usefully be considered at a national level (and some issues are UK specific). The international context and the potential impact on the relative competitiveness of the UK investment and non-financial corporate industry of any remedies proposed in a market study would be carefully considered.

2.42 For these reasons, we have decided to undertake a study which will consider the effects of transparency and bundling in investment banking and corporate banking services. The full scope of the market study will be set out in a terms of reference document, which will be published upon launch of the market study, which is expected to be in spring 2015.

35 Increased trade transparency requirements and requirements relating to trading venues and dark pools are discrete topics which we do not expect to significantly impact the scope of a market study relating to bundling and transparency. Forthcoming changes in relation to best execution (together with the findings from the recent FCA thematic review) mean that it may not be a good time to look at this.
MiFID II contains three aspects pertaining to bundling in investment banking:
1. Article 24(11) of Directive 2014/65/EC requires that firms inform clients whether it is possible to buy bundled services separately and to provide separate evidence of the costs and charges of each component (this would not apply where the person an investment bank is dealing with is an eligible counterparty under the MiFID client categorisation regime).
2. ESMA has in its technical advice to the European Commission on MiFID II/MiFIR's delegated acts advised that payment for research be separated from payment for execution services.
3. ESMA has in its technical advice to the European Commission on MiFID II/MiFIR advised that new conflicts rules on underwriting are introduced which would, amongst other things, seek to prevent a situation in which there is implicit bundling of certain services.

3.
Summary of feedback – Asset management

Summary:

- Some features of the purchase and provision of asset management and related services may mean competition is not working effectively in this market:
  - Investors may not be able to assess effectively whether they are getting value for money for asset management and investment consulting services;
  - Asset managers may not have sufficient incentives or ability to control costs incurred on behalf of investors along the asset management value chain; and
  - The bundling of some ancillary services may impact the way competition works for these services.
- We will undertake a market study into asset management and related services in the future to identify whether competition is working effectively.

Overview

3.1 The UK asset management sector accounts for approximately 35% of total European assets under management (AUM). Of this, approximately £5.4 trillion institutional assets are managed from the UK for an annual management fee of circa £13 billion.[36] The effectiveness of competition in the supply of asset management and related services has an impact on the investments and pension funds of millions of end consumers. In addition, the industry is a significant source of funding for the economy, with asset managers and hedge funds participating in debt and equity issuance on behalf of the funds they manage, which enables companies in the real economy to fund investments and ongoing operations.

3.2 Effective competition should result in the right price being charged for the right level of service for both asset management and related services, benefitting end investors and the economy as a whole. If funds are overcharged for asset management or ancillary services, the value of the funds will be reduced, and ultimately the value of end consumers' pensions or investments.

3.3 The asset management industry is not concentrated either at the fund or firm level; for example, there were over 35,000 European funds at the end of 2013.[37] In addition, barriers to entry in the market for asset management services more generally seem relatively low.[38] In addition,

36 IMA, Annual Asset Management Survey, 2013

37 Lipper, 2013

38 For example, the UK saw a growth in authorised funds of 16% in 2013 (IMA annual asset management survey, 2013) and a growth of 8% in the number of authorised Investment Management firms from 2008/09 to 2014 (FCA Data Bulletin October 2014 edition).

we have identified some evidence of innovation in the market. For example, the resurgence of 'smart beta'[39] strategies in Exchange Traded Funds (ETFs) and the increase of the proportion of funds utilising alternative[40] assets. Innovation could suggest that firms are attempting to achieve sustainable competitive advantage over rival firms.[41]

3.4 Although there are a large number of funds offered, concentration may be higher for certain, more specialist, mandates. For example, in one survey, the top three managers by size represented 90% of the UK market for Liability Driven Investment[42] based on notional value.[43] Furthermore, concentration for some ancillary services may be high, which may make it difficult for asset managers or institutional investors to negotiate for better quality services or lower prices, where few alternatives exist.

3.5 Despite many competing firms and low barriers to entry, the average industry profitability is high and this, along with some other features of the market (e.g. information asymmetries) may indicate that competition is not working as effectively as it could be.

3.6 Asset managers often act as an agent for their clients, and in some circumstances the interests of the principal and the agent may not be aligned. Where this is the case, there is a risk that the asset manager will not act in the best interests of their clients. Where clients are not able to effectively monitor the value for money achieved by the asset manager they will be unable to take action based on this information by, for example, switching to an alternative provider. Where clients cannot respond effectively to asset managers who do not act in their best interests, it may be difficult for them to achieve value for money when purchasing these services.

Responses to the call for inputs

3.7 The responses we received to the call for inputs raised issues around both how asset management services are supplied and how they are bought.

3.8 The responses related mainly to:

- The purchase of asset management services: whether wholesale investors are able to effectively assess quality and value for money offered by asset managers;
- The incentives of asset managers: the extent to which asset managers have incentives to negotiate the best deal for services purchased on behalf of investors; and
- Ancillary services:[44] whether the bundling of ancillary services is in the best interests of funds and investors.

39 'Smart beta' here means those investment styles which passively follow an index but use alternative weighting (such as momentum, dividends or volatility) instead of traditional market cap weighting. These strategies attempt to achieve a better risk and return trade off by taking advantage of perceived market inefficiencies.

40 'Alternative' in this context might include private equity, commodities and use of derivatives to achieve certain targeted strategies.

41 By innovation, we mean genuine innovation rather than artificial product differentiation. We do not consider that innovation which weakens consumer understanding or adds unnecessary complexity would suggest that competition is working effectively.

42 A liability driven investment is a mandate where the investment strategy is based on the requirement for cash flow to meet both current and future liabilities as they fall due (this requires that the future cash flows can be predicted). It is commonly used to describe a range of investment strategies designed for situations where future liabilities can be predicted. It differs from benchmark-driven investment strategy which is based on achieving better returns than an index. Notional value is the value of liabilities whose interest rate or inflation risk has been hedged.

43 2013 KPMG LDI Survey. Available at: www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Tax/ldi-survey-june-2013v2.pdf

44 We have used 'ancillary services' here to mean any services which may be bought alongside core asset management services. The meaning should therefore not be taken as in the MiFID II glossary of term as it may include other services.

Responses to the call for inputs on purchasing asset management services

- A body representing wholesale purchasers argued there is a perception among some pension scheme trustees that the value and service offered by many fund managers is poor and that a lack of effective competition plays a part in this.

- Several respondents argued that the ability of institutional investors to assess the value of asset management services varies significantly. In some instances institutional investors have the expertise and resources to effectively scrutinise the services they receive. However, in other cases with some pension trustees, those overseeing the selection and oversight of asset managers may lack the necessary resource and/or expertise to do this effectively.

- Some purchasers of asset management services argued that non-disclosure clauses in fund management agreements are a hindrance to competition as they make it hard for pension trustees to know if they are getting a good price relative to others. One respondent also noted that 'most favoured nation clauses'[45] can reduce the ability of subsequent investors to negotiate a low price.

- One respondent noted that there are differing levels of competition for different types of investment mandate and that there are relatively few investment managers able to manage large-scale Liability Driven Investment mandates. A concentrated market with fewer options to choose from could reduce the ability of investors to negotiate a good deal.

- A number of respondents commented on the advisory role investment consultants play when advising institutional clients purchase asset management services. Some respondents noted that investment consultants encourage clients to look at factors other than just charges and performance, such as governance. They viewed this broader assessment of value as positive for competition.

- Conversely, one respondent suggested that consultants do not focus sufficiently on fund charges; consequently these are inadequately considered by many institutional investors, although this was not the view of all respondents.

- It was suggested that investment consultants may be incentivised to advise clients to select active fund strategies to justify the fees which are paid to them for their advice. This may result in an overconsumption of active (compared to passive) investment management services which may not be in the interests of the end consumers.

- A small number of respondents noted that some investment consultants offer fund management, fund selection and asset allocation services. They noted that competition might not work effectively if the conflict of interest between advising and providing investment products is not effectively managed.

Continued on page 30…

45 Most favoured nation clauses are contractual terms agreed between firms at different levels of the value chain. They usually stipulate that a seller will offer its goods or services to the counterparty on terms that are as good as the best terms offered to third parties. This definition is taken from Oxera (2014), *Most-favoured-nation clauses: falling out of favour?*, www.oxera.com/Latest-Thinking/Agenda/2014/Most-favoured-nation-clauses-falling-out-of-favour.aspx?utm_source=Agenda&utm_campaign=7ef4517beb-Agenda&utm_medium=email&utm_term=0_30f4ff7c95-7ef4517beb-1749117

...continued from page 29

- One respondent felt that pension trustees often find it difficult to assess the quality of advice given by investment consultants. For example, only a small proportion of defined contribution schemes had a formal process to assess the quality of the services provided by investment consultants.

- A small number of respondents also observed that the market for investment consultancy services was concentrated with a few dominant providers.

Purchasing asset management services: our analysis

3.9 Actively managed assets account for the majority of the UK AUM managed for institutional clients (65%).[46] Asset managers promoting active strategies do not primarily compete for customers on the basis of fees. Instead they appear to compete on past performance and the perception of the managers' ability to achieve future performance.[47]

3.10 Fee structures for asset management services are primarily a percentage of the AUM and are not necessarily linked to costs incurred. Where fees and charges are not transparent or linked to the costs incurred, it may be difficult for clients to assess whether they are getting value for money. This may inhibit their ability to negotiate effectively for a good deal, or switch providers if they are receiving a poor service.

3.11 There have been several recent publications discussing disclosure and transparency of fund charges. In 2012, the Investment Management Association (IMA) set out best practice guides[48] for the disclosure of charges and costs of investment managers. The Association of British Insurers (ABI) and National Association of Pension Funds (NAPF), in association with the IMA and Society of Pension Consultants (SPC), published 'Pension charges made clear: code of conduct'[49] which outlined similar requirements regarding fees for defined contribution pension providers. In addition, individual investment consultants conduct annual surveys on investment manager fees and publish their findings. The FCA found that using the ongoing charges figure (OCF)[50] consistently in all marketing material for UCITS[51] funds is likely to help investors understand and compare charges.[52]

3.12 While increased disclosure initiatives are in place it is not clear whether this will be sufficient to improve investors' ability to select the funds that offer the best value for money. Investors appear to make decisions based on past performance,[53] reputation, and other features such as marketing and advertisement.[54] This may mean that asset managers do not focus on reducing

46 IMA Annual Asset Management Survey 2013 – Sample adjusted third party managed figure.

47 For example, see Bergstresser & Poterba (2002), Sapp & Tiwari (2004), Del Guercio & Tkac (2008)

48 IMA, 2012

49 www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0273_Pensions_charges_made_clear_code_of_Conduct.ashx

50 The OCF represents the ongoing costs to the fund, which includes the annual management charge (AMC) and other charges for services such as keeping a register of investors, calculating the price of the fund's units or shares and keeping the fund's assets safe. This definition was taken from the Financial Conduct Authority (2014) *Clarity of fund charges* www.fca.org.uk/static/documents/thematic-reviews/tr1407.pdf

51 Undertakings for the collective investment of transferable securities

52 *Clarity of fund charges* www.fca.org.uk/static/documents/thematic-reviews/tr1407.pdf
For evidence on retail investors see for example Choi, James J., David Laibson, and Brigitte C. Madrian. "Why does the law of one price fail? An experiment on index mutual funds." Review of Financial Studies 23.4 (2010): 1405-1432.

53 Laibson, Madrian, Choi paper on people relying on past performance even in the case of trackers.

54 For example, see Barber, Odean & Zheng, 2005.

prices to win clients but instead may compete on these other characteristics. In addition, an over-reliance on past performance and/or reputation is likely to act as a barrier to entry for new funds which do not currently have a track record. It is possible that behavioural bias such as over-extrapolation[55] and decision-making rules of thumb[56] including herding[57] behaviour may contribute to this effect.[58]

3.13 Investment consultants are often instructed by institutional investors to assist in making investment decisions. In 2014 it was estimated that $25 trillion of institutional assets worldwide are advised on by investment consultants.[59] For US equity funds it was found that consultants' recommendations, while driven to some extent by past performance of fund managers, are related strongly with non-performance factors. The authors found little evidence that the recommendations of investment consultants enabled investors to outperform their benchmarks.

3.14 In the UK, investment consulting is a relatively concentrated industry, with a small number of suppliers advising on a large proportion of pension funds. Investment consultants may be incentivised to recommend active rather than passive strategies, for example, to justify the advisory fees that they are charging. This is because choosing between active funds is likely to be more complex and therefore require more detailed and expensive analysis when compared to recommending passive funds. Over-consumption of actively managed or higher cost funds that do not deliver performance that justifies these fees will result in investors achieving sub-optimal investment outcomes. For some institutional investors more expensive or actively managed funds may not be the most appropriate for their needs.[60]

3.15 In addition to advice on fund selection, some investment consultants also offer asset management services. As in any model where the adviser is also the potential product provider this may present conflicts of interest. In this model investment consultants may have an incentive to promote their own asset management services above those of their competitors and potentially against the best interest of their client. This problem may be compounded if clients are unable to accurately assess the quality of advice they are receiving. This conflict of interest would therefore need to be carefully managed.

55 People often make predictions on the basis of only a few observations, when these observations are not representative.

56 Consumers simplify complex decision problems by adopting specific rules of thumb (heuristics).

57 Adopting a rule of thumb or being persuaded by social influences to accept that the most popular investments will be the best without making a careful allocation decision.

58 There are multiple studies on behavioural bias in investment. See (Bailey, Kumar, & Ng, 2010) for an overview of behavioural biases of investors in mutual funds. On return chasing behaviour by US plan sponsors:
Goyal, Amit, and Sunil Wahal. "The selection and termination of investment management firms by plan sponsors." The Journal of Finance 63.4 (2008): 1805-1847.

59 Jenkinson, T., Jones, H., and Martinez, J. V., 2014, Picking Winners? Investment Consultants' Recommendations of Fund Managers. *Journal of Finance (Forthcoming)*, Available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2327042 [Accessed 5th February 2015].

60 Active investment also constitutes a positive externality to society by potentially improving the accuracy of financial prices. See French, Kenneth R. "Presidential address: The cost of active investing." The Journal of Finance 63.4 (2008): 1537-1573.

Responses to the call for inputs on asset managers' incentives and behaviours

- Some asset managers commented that some institutional investors may not have the expertise to effectively monitor asset managers.

- The FCA's Consumer Panel recently published three reports[61] which argued that some investors cannot effectively oversee asset managers' transactions costs due to a lack of transparency. A lack of investor oversight in this area reduces asset managers' incentives to manage these costs effectively. A number of respondents expressed concern that fund-level governance may also be ineffective at overseeing costs.

- Some asset management firms said they have strong incentives to control costs paid for by the fund, as this forms part of net performance which is an important driver of growth in funds under management and future fee income. They argued that the incentives of asset managers are therefore aligned with the investors' objective to maximise net performance. One asset management firm noted that its fund management employees are 'significantly' invested in funds they manage and this also leads to alignment of incentives at an employee level.

- However, one asset management firm noted that where there is a significant cost to the fund management firm to negotiate and monitor services paid for by the fund. When any cost savings would not sufficiently impact net performance their incentives may not be aligned with investors. This is because firms might not be incentivised to manage those costs effectively, even when they could be significant in absolute terms, if this only has a very small percentage impact on return.

- One asset management firm argued that if institutional investors do not receive a satisfactory service, it is simple for them to switch to another asset manager. This, the firm argued, ensured that firms' incentives are aligned to investors as otherwise they would lose their clients.

- Another respondent highlighted that mandatory reporting obligations ensure institutional investors have access to a significant amount of information. This should enable them to assess performance, including [non-transaction] charges and expenses and governance arrangements. The respondent added that investors are free to request additional, more detailed information should they require it.

- Several respondents commented on asset managers' oversight of dealing commissions. We undertook work to clarify and enhance the use of dealing commissions rules in 2014.[62] Broadly, respondents were in agreement that wider use of Commission Sharing Agreements (CSAs)[63] could increase competition. One respondent argued that CSAs help to lower barriers to entry into asset management by allowing newly established asset managers to consume research before taking investment decisions (and therefore generating dealing commission), rather than being forced to commit large sums to purchase research before investment and therefore returns. Respondents argued that potential MiFID II rule changes could ban the payment for research from dealing commissions and this could lead to increased concentration of commission payments to a smaller number of providers. Subsequent to our call for inputs exercise, ESMA's technical advice to the European Commission on this issue was finalised.[64]

61 www.fs-cp.org.uk/publications/research_documents.shtml

62 Outsourcing in the Asset Management Industry: Thematic Project Findings Report www.fca.org.uk/your-fca/documents/thematic-reviews/tr13-10

63 CSAs are agreements between investment managers and brokers that specify that a certain proportion of dealing commission sent to a broker be reserved to pay for research (which could be that of the executing broker or another entity). This definition was taken from the Financial Services Authority (2008) *Use of dealing commission – results of thematic review* www.fsa.gov.uk/pubs/other/Dealing_Commission.pdf.

64 The technical advice clarifies the circumstances in which portfolio managers can receive research from third parties. See: www.esma.europa.eu/content/Technical-Advice-Commission-MiFID-II-and-MiFIR

Asset managers' incentives and behaviours: our analysis

3.16 Asset managers commonly outsource some services such as custody banking and fund administration. Some of these services are paid for by the fund investors (the clients), whilst other costs are borne by the asset management firm. When purchasing these services on behalf of clients there is potential for the interests of the asset manager (acting as 'agent' in the relationship) to differ from those of the investors ('principal').[65]

3.17 This may have implications for the effectiveness of competition between suppliers where competition is aimed at winning custom from asset managers rather than directly targeting the interests of fund investors. It is possible that asset managers may value some aspects of the service more than the investors, or may look to achieve value for money over their total fund business rather than on a fund by fund level. For example, asset managers may value the ease of use and oversight of a service more than the cost. In this example ease of use may represent a saving in time for the asset manager, but could represent a greater expense and might therefore run counter to the investors' requirements. However, many of the costs which are paid for from the fund will be reflected in the fund's net performance, and therefore asset managers may have an incentive to reduce the costs which materially affect net performance.

3.18 Where asset managers' interests differ from those of the investor and if the investor is able to monitor the service then this may not be problematic. For example, the investor may take action by switching to an alternative provider who can demonstrate that their incentives are better aligned to the investor's. However, where the investor is not able to effectively monitor the asset manager they may be unable to take action against failing or unsuitable providers and this could reduce competitive pressure. The incentives and ability of clients to monitor the asset manager may vary between clients. It may be that sophisticated institutional clients are better able to anticipate and monitor the asset manager than less sophisticated clients.

3.19 It is possible that 'closet tracking' could be indicative of market structures which have allowed asset managers' and investor's incentives to be misaligned. 'Closet tracking' is the practice whereby funds are labelled as actively managed but track their reference benchmark. They therefore produce gross returns in line with a passive fund which tracks that benchmark. Investors could be charged a higher fee for an actively managed service, and net returns are typically much lower because of the higher charge paid for an active fund over a passive fund. ESMA is gathering more information in this area and we continue to support their review.

65 Although the asset manager in a funds context is appointed by the fund, the ultimate owners of the fund are the end-investors and therefore we consider that this relationship can be described as one of principal-agent.

Responses to the call for inputs on ancillary services

- We received a number of responses on the provision of ancillary services. Some ancillary services are paid for by the asset manager and others directly by the fund investors or institutional client.
- A number of respondents commented on the markets for outsourced and ancillary services in general, noting high levels of concentration and bundled offerings in custody banking.
- Pension fund representatives commented that services bundled with core custody services are neglected and that they were not getting a good deal. Respondents noted that there are a narrow range of providers and they are unresponsive to client needs. For example, these respondents felt that the voting services[66] provided by custody banks have seen low levels of innovation and they are concerned that voting instructions might not get accurately executed due to the lack of investment in an automated effective process.
- Some respondents noted that some services, including custody banking and ancillary services, may be high volume and low margin businesses and it may be difficult for new entrants to enter and compete due to the economies of scale available to incumbents.
- Several respondents noted that a large proportion of ancillary services are commoditised and therefore the biggest differentiator is price. Some asset managers commented that outsourcing of ancillary services, for example those offered by custodians, has resulted in downward pressure on price as economies of scale are available to larger outsourcing providers.
- Several asset managers explained that when purchasing services they search for good value and this can lead to the purchase of bundled services. Broadly, respondents were in agreement that bundled services are cheaper and a small number of respondents noted that there are economies of scope[67] for providers if services are packaged together. One respondent added that there are benefits to both the asset manager and the investor of a 'one stop shop' model for services and mentioned the use of a single IT interface as an example of such an advantage. One asset manager drew our attention to the fact that whilst it purchases bundled services, the price of each component service is transparent.
- A number of respondents noted that competition in the market for transitions management services[68] is effective despite high concentration, due to the tender process.

Ancillary services: our analysis

3.20 The FCA recently undertook a thematic project[69] on outsourcing in the asset management industry which is relevant to the purchase of ancillary services. The project focused on assessing two key areas of risk relating to outsourcing. This included asset managers having inadequate contingency plans and applying inadequate oversight. Though progress had been made,

66 Voting services might include processing proxy votes, managing the relationship with custodian banks, executing votes on behalf of unit holders, maintaining records of voting and providing reporting.

67 Economies of scope exist when it is cheaper to produce two products together than to produce them separately (OECD, 2008).

68 A service provided to clients to support structural changes to asset portfolios with the intention of managing risk and increasing portfolio returns.

69 *Outsourcing in the Asset Management Industry: Thematic Project Findings Report* www.fca.org.uk/static/documents/thematic-reviews/tr13-10.pdf.

the report concluded that asset managers should review their outsourcing arrangements to enhance their contingency plans and assess the effectiveness of their oversight arrangements.

3.21 A lack of oversight of outsourcing agreements and general scrutiny of services purchased on behalf of investors could indicate that incentives are not fully aligned with those of investors.

3.22 The potential issues and efficiencies associated with bundling of services as identified above in the investment banking analysis are likely to hold for the asset management industry. Where the costs of components of the bundle are available, sophisticated clients may effectively assess value for money. However, where bundled services are paid for by the fund, there is a risk that the principal-agent issues exist and the asset manager does not effectively assess value for money. In addition, bundling in asset management may be driven by the asset manager, who may not be incentivised to improve transparency for end investors.

3.23 High levels of concentration in the provision of some ancillary services can be observed. For example, FCA research[70] found the transitions management market to be concentrated with 68% of transitions by number and nearly 80% of volume of assets traded accounted for by the top five firms included in the review. Where this is the case, there are fewer options for the client to select from and switch to where it is dissatisfied with its current service provider. It may also be more difficult for a client to negotiate a better deal with its current provider where it has few alternatives to switch to, and may reduce the incentive for providers to innovate to meet the needs of clients. Users of certain ancillary services may also face high switching costs, either as the tender process is perceived to be costly and time consuming compared to the potential benefits gained, or because there may be risks associated with switching providers. For example, switching providers may present problems with systems portability or delays in the implementation of a new provider could result in a gap in service.

3.24 Custody is frequently purchased directly by institutional clients and therefore those with high bargaining power (those with large assets under management, and expertise of the sector) may be more able shop around for a better deal, compared to smaller institutional clients. Where asset managers purchase services on behalf of their clients, the principal agent issues described above may prevent asset managers from getting the best deal for their client (for example if the costs of negotiating and/or switching outweigh the benefits to the asset manager and this practice does not create a competitive advantage for the asset manager). This is evidenced by a wide range of fees charged for similar services in some cases.

3.25 Similarly, certain types of service user may be more likely to switch providers due to cost consciousness or concerns over quality of service. For example, those that have more experience of negotiations in the sector; one survey[71] found that 56% of hedge funds based in Europe had changed fund administrator in the past five years.

Market study suitability

3.26 Based on the responses received and our own analysis, we consider that there are areas in the procurement and supply of asset management, and related services, where competition may not be working effectively. These include:

- The difficulty which some institutional investors have in negotiating fees and monitoring asset managers;

70 *Transition management review* www.fca.org.uk/static/documents/thematic-reviews/tr14-01.pdf

71 Prequin Special Report: Hedge Fund Service Providers (February 2014) www.preqin.com/docs/reports/Preqin_Special_Report_Service_Providers_Feb_14.pdf

- The role of investment consultants and potential conflicts of interest arising from the provision of advice and asset management services;
- The incentives and ability of asset managers to control costs incurred on behalf of investors along the asset management value chain; and
- Bundling of some ancillary services and the quality of some services provided.

3.27 We think it would be beneficial to have a broad market study considering both the supply and demand side of asset management to investigate some or all of these issues further.

3.28 Based on our prioritisation criteria, we consider that the wholesale purchase of asset management, and related services, would be a suitable candidate for a market study because:

- Taking into account the responses and other work, we believe that there are areas of this market where competition may not be working effectively. Given the size of this market even a small improvement in the effectiveness of competition could lead to substantial benefits to investors; a one basis point of cost saving would be worth circa £540 million a year.[72] We therefore believe that the potential impact on consumers and impact of any enhancements to competition could be significant.
- A market study into asset management and related services would primarily focus on activities that are within our regulatory perimeter (such as managing investments, safeguarding and administering investments, managing an AIF, managing a UCITS and advising on investments). However, the scope of the market study may include activities that are outside our regulatory perimeter where these activities affect how competition works in the market in question, such as certain activities undertaken by investment consultants, including providing general investment advice.
- It is possible that any remedies proposed in the market study could also have a positive impact on competition in the retail asset management sector. However, any changes made in the wholesale market which are likely to have read-across to the retail market would need to be carefully considered. In wholesale markets ancillary services, for example custody banking, are often purchased directly by institutional investors. However, any improvements to the effectiveness of competition for such ancillary services may also be significant when these services are paid for by asset managers on behalf of their retail funds and this may reduce the fees charged to both wholesale and retail funds.
- We do not consider that the asset management sector is likely to be subject to major non-regulatory change that would make a market study inappropriate.
- Asset management is a global industry, but many of the issues raised in the call for inputs can usefully be considered at a national level (albeit in full awareness of the international context). The potential impact on the relative competitiveness of the UK asset management industry of any remedies proposed in a market study would be carefully considered. Remedies that are imposed in the UK could also be considered at a European level.

72 Estimate assuming that there are approximately £5.4tn institutional assets managed from the UK, IMA figure.

3.29 However, we consider that a number of upcoming regulatory changes will have a significant impact on asset management,[73] for example:

- MiFID II/MiFIR intends to significantly strengthen investor protection in several ways. We are unable to predict all of the implications of the changes in MiFID II on how competition works for asset management services. However, these regulatory developments are expected to have an impact for the asset management industry and may affect potential competition issues in several ways. For example, requirements to provide certain information on costs and charges, requirements to disclose whether bundled products can be bought separately and the regime for third country access could all have implications for competition issues identified above. We consider it may be appropriate to wait until we are better able to anticipate industry's response to the changes, before undertaking a market study.

- There is both FCA and DWP work currently ongoing in relation to defined contribution pension schemes, making recommendations covering governance, charges and transaction costs. These recommendations are likely to have implications for the way the participants in the pension scheme market compete.

3.30 There are also recent regulatory developments that may continue to change the way that competition works in this market, for example:

- AIFMD may, to some extent, continue to build on MiFID rules for some of the issues identified. For example, a full-scope AIFM must appoint a depository who is required, amongst other things, to monitor whether the AIFM complies with investment restrictions and leverage limits. Full-scope AIFMs are required to disclose all fees, charges and expenses to investors before they invest as well as any material changes in costs. Full scope AIFMs are also required to act in the best interest of investors and to monitor and manage conflicts of interest.

- The FCA recently undertook a thematic review[74] examining outsourcing in asset management. Previous work in this area had suggested that asset managers may be applying inadequate oversight of their service providers, though the results of this review were encouraging. The FCA also undertook a thematic review[75] examining the Transition Management market. The findings and next steps from both of these reviews set out expectations which may have implications for the way that asset managers instruct and monitor ancillary service providers.

- The FCA also recently undertook a thematic review[76] examining the clarity of fund charges. Among other findings, this found that some firms continue to refer to different or complex charging structures in documents and marketing material which makes effective comparisons difficult. The expectation of firms set out in our rhematic review was that they should be satisfied that their practices in relation to the clarity of charge information and fund governance are appropriate. This message applies to those funds which are marketed to all types of investors.

73 For example, Markets in Financial Instruments Directive II (MiFID II), PRIIPS and Undertakings in Collective Investment in Transferrable Securities V (UCITS V) will touch on certain aspects of the asset management industry.

74 *Outsourcing in the Asset Management Industry: Thematic Project Findings Report* www.fca.org.uk/your-fca/documents/thematic-reviews/tr13-10

75 *Transition management review* www.fca.org.uk/news/tr14-01-transition-management-review

76 *Clarity of fund charges* www.fca.org.uk/news/tr147-clarity-of-fund-charges

3.31 As explained in section 1, we have chosen to prioritise a market study assessing investment and corporate banking services. However, based on the responses and analysis to date, we would expect to undertake a market study looking at asset management and related services in the future. Based on our current understanding of the market, we would expect to focus on how wholesale purchasers get value for money when buying asset management services. We would anticipate undertaking this study once we have better indications of how the industry will evolve to accommodate new regulations. Before undertaking a market study, we will consider the impact of the ongoing work streams of various organisations in the UK and Europe and will assess the extent to which any competition issues identified have been resolved.

4. Summary of feedback – Markets and market infrastructure

Summary:

- The following features of the markets and market infrastructure may mean competition is not working effectively;
  - the potential for data providers (including exchanges, data vendors, and licence and benchmark providers) to exploit their market power;
  - the vertical integration model of CCPs and trading venues may create barriers to entry/expansion for stand-alone providers trying to compete;
  - a reduction in the number of clearing providers and questions as to whether those requiring clearing services are able to obtain them on a fair, reasonable and transparent basis; and
  - the potential for providers of co-location services to exploit their market power.
- There is ongoing and forthcoming regulation which is expected to affect the way competition works for the majority of these services, therefore we do not think it is appropriate to prioritise a market study into these issues at this time.

Overview

4.1 Financial markets, ranging from equities to derivatives and commodities primarily exist to ensure that buyers and sellers of financial instruments can meet and transact in a secure and effective manner. Effective competition in markets and associated infrastructure is important for a number of reasons including price determination, transfer of risk and the productive use of capital.

4.2 Given the importance of these markets, they have been subject to regulations which have sought to improve the effectiveness of competition. The original Markets in Financial Instruments Directive ("MiFID") set out, in part, to introduce competition to the EU trading landscape and provided a 'passport' for trading venues and investment firms to operate throughout Europe. The changes brought about by this regulation significantly altered the structure and competition dynamics in the UK markets and, in particular, the UK equity markets.

4.3 The global industry has undergone significant consolidation over the last decade. This has led to international competition authorities examining the potential for competition issues to arise. For example, the proposed merger of Deutsche Borse and NYSE Euronext was blocked due to concerns from the European Commission.[77] In particular, the Commission felt that the merger could have created an entity with a potential dominant position in European exchange traded derivatives.

4.4 This period of consolidation may be a result of potential economies of scale[78] and scope that exist within these markets. The demutualisation of global exchanges is also likely to have been an important driver behind this consolidation as exchange groups move to seek returns on equity. Regulatory changes may also have impacted decisions around consolidation.

4.5 There is evidence to suggest that, where competition has increased, it has introduced benefits to markets and market infrastructure. For example, the introduction of MiFID is estimated to have lowered the price of trade execution in the UK equity markets.[79]

4.6 In general, market infrastructure appears concentrated. When looking at the UK equity markets,[80] the vast majority of lit venue[81] trading in the UK occurs between two trading venue groups. The decrease in the cost of execution in these markets may suggest that competition in this market is working effectively. However, trading venues may have sought to offset this loss of revenue from other sources, particularly those sources where competition may not be as effective. For example, our analysis suggests that competition may not be working as effectively for the provision of data services.

4.7 Other aspects of market infrastructure also appear concentrated. For example, there are still only a small number of CCPs and clearing houses.[82] When examining the type of instruments which UK recognised CCPs are authorised to clear, the concentration for certain instrument classes appears higher than at CCP level.

4.8 Within market infrastructure, there appears to be the ability for monopoly power to be exerted on users, either in the form of high prices or bundling of monopoly services with other services to foreclose entry. This could be the case for certain trade data where users require data from specific venues to meet their business needs and regulatory requirements. In this case the exchange may have a monopoly over the data they hold.

4.9 We understand that network effects exist for trading venues, whereby the greater the number of participants trading on the venue, the more desirable the trading venue is likely to be for other users. This is because in general, the more market participants trading a given instrument on a specific trading venue, the greater the chance that users will find someone to trade with. However, the increased choice as a result of a greater number of trading venues may lead to lower fees, improved quality of service or alternative fee structures which could benefit the user. So there appears to be a balance between ensuring effective competition and the effective functioning of the wholesale markets. The fragmentation of markets could risk a

77 http://europa.eu/rapid/press-release_IP-12-94_en.htm
78 MiFID, Reg NMS and competition across trading venues in Europe and the USA, Journal of finance www.emeraldinsight.com/doi/full/10.1108/13581981011060826
79 www.gov.uk/government/uploads/system/uploads/attachment_data/file/289027/12-1054-dr21-high-frequency-trading-execution-costs-of-institutional-investors.pdf
80 http://fragmentation.fidessa.com/fragulator/?fim=.UKX (These figures provide an indication).
81 Lit venues are those where bid-ask spreads are publically displayed.
82 www.bankofengland.co.uk/financialstability/Pages/fmis/supervised_sys/rch.aspx

decrease in the ease of sourcing market liquidity. There can be additional costs associated with fragmentation, such as data linkages to multiple exchanges. However, excessive consolidation may lead to the formation of monopolies and potentially lead to abusive market practices.[83]

Summary of responses

4.10 We received a number of responses highlighting areas where competition may not be working effectively in relation to both markets and market infrastructure. The issues raised focused primarily on secondary markets and post trade, including:

- The production and dissemination of trade data;
- Arrangements between Central Counterparties (CCPs) and trading venues;
- Access to clearing services for over-the-counter (OTC) derivatives; and
- Co-location of firm servers at exchanges.

4.11 The responses we received generally focus on market infrastructure, rather than the markets themselves. However, potential competition issues within fixed income, currency and commodity markets (FICC) are being considered as part of FEMR.[84] If the FEMR consultation identifies any competition issues within FICC markets, we may consider further investigation of these issues.

The production and dissemination of data

4.12 Within the call for inputs, we suggested that there may be potential competition issues associated with trade and other market data. Potential issues could include excessive charging due to dominant market position, a lack of transparency for pricing and barriers to switching. Data in this context includes data produced by trading venues and other platforms, data packaged and/or redistributed by vendors and licensing arrangements for purposes such as the creation of indices and benchmarks.

83 These issues are discussed in the FEMR consultation in relation to FICC markets www.bankofengland.co.uk/markets/Documents/femr/consultation271014.pdf

84 Section 5 of the FEMR consultation

Responses to the call for inputs on the production and dissemination of data

- We received a number of opposing views on this issue, and the arguments raised in responses were broadly aligned with whether respondents were primarily 'users', such as banks, asset managers and brokers, or 'producers' of data, such as trading venues.
- Most 'users', told us that costs for data are currently too high and have noted a recent increase in the overall cost of data throughout the value chain.
- Some respondents highlighted that certain data, for example non-display data[85] for inclusion in algorithms, is an essential requirement in financial markets (for example, for automated trading). It was suggested that there is no bargaining power for users of data and this creates a dominant position for the data producers, allowing them to increase prices. This may mean that some firms will be required to purchase data from all relevant exchanges, even if the exchange in question is small. One respondent suggested that certain categories of data, such as data that a firm had no choice but to buy in order to meet regulatory obligations, should be afforded special pricing protection.
- In addition, some respondents noted a lack of transparency and complexity of pricing in relation to data from trading venues.
- A number of respondents noted that bundling appears to be a common occurrence in the data market at both vendor and exchange level. Some respondents noted that instant messaging services, an essential part of OTC trading, are bundled with data services. At the exchange level, users reported auction data being bundled with continuous trading prices. One respondent explained that data services can overlap, so the same piece of data is paid for multiple times and this leads to inefficiency.
- Generally, 'producers' of the data (trading venues) argued that data is currently charged at a reasonable level. One respondent suggested the commercial incentives to make market data widely available will ultimately keep costs down. Another respondent suggested current pricing models allow flexibility of price to suit the needs of the end user.
- Some respondents argued that the majority of costs are at the data vendor level of the data chain. As evidence of this, some respondents cited the recent Oxera report[86] on pricing of market data services as an indication of the costs attributable to data vendor services. This report also highlighted the costs attributable to the exchange and IT infrastructure associated with the use of data. However, other respondents disputed the findings of this report.
- One respondent argued that the proposals relating to trade data, discussed in MiFID II would not go far enough to solve the issues relating to the cost of data.[87] It was noted that the consolidated tape will only solve post trade transparency issues.

85 By non-display data we mean market data that is not for human use and provides market data for automated programme trading.

86 Oxera (2014), 'Pricing of market data services: An economic analysis': [Accessed 28th November 2014].

87 MiFID II/MiFIR brings in several requirements designed to enhance consolidation and disclosure of trading data. Rules have been introduced regarding the obligation for trading venues to make pre and post-trade data available on a reasonable commercial basis and through the establishment of conditions to be authorised as a consolidated tape provider for post-trade data. These rules are accompanied by the establishment of approved publication arrangements for trade reporting and approved reporting arrangements for submitting transaction reports to competent authorities. For more information on MiFID II, see: www.esma.europa.eu/page/MiFID-II-application [Accessed 2nd December 2014].

Production and dissemination of data: our analysis

4.13 While European trading venues are competing for trade execution services, venues may be able to exercise market power when deciding how much to charge for access to their data feeds, both pre- and post-trade. This market power will be higher for data where exchanges are in a dominant position, for example where an exchange has most of the volume traded in particular instruments, or opening auction data.

4.14 Market participants need both pre- and post-trade information (price and depth of order book) from various venues in order to execute their trades at the best available price and to find the level of liquidity needed. Market participants may be unable to switch to alternative products, leading to low price elasticities. The cost of trading for investors therefore depends both on trading fees (incorporating infrastructure costs) and on the costs of data necessary to trade. If venues have market power because their data is unique and users need it for their own trading purposes or to meet regulatory requirements, they may be able to charge excessive prices for data. Consistent with this, post-MiFID, respondents suggest many European trading venues appear to have increased the prices of data and potentially the revenues generated from data services.

4.15 If liquidity of an instrument is concentrated on just one exchange it may be sufficient to only buy the trade feed of this exchange. However, in fragmented European markets it is often not sufficient to monitor the price on one exchange only. Market participants wishing to execute trades in a certain financial instrument during primary market auctions may have little choice but to buy the trade data feeds from the primary markets. Similar issues exist with data for indices or other benchmarks necessary to price or construct a financial instrument.

4.16 Often, investors need data from venues with a significant share of market liquidity in a specific instrument to achieve best execution of their trades. The best execution obligation in MiFID requires dealers and investment firms to provide information to their clients on order execution policy, including information on the different trading venues where orders for each class of instrument are executed, and the factors affecting the choice of execution venue. Further, under MiFID II investment firms will be required to make public on an annual basis the top five trading venues used for each class of instruments in the preceding year, and information on the quality of execution obtained.

4.17 Evidence commissioned by exchanges[88] suggests that the average cost of trade data is higher in Europe than in the US. However, comparisons of prices are very difficult to make due to differences in market structure. For example, Reg NMS[89] implies that trading venues will be interconnected, as trading venues have a responsibility to ensure trades are executed at the best price. This interconnectedness is likely to have a direct impact on the flow and standardisation of data between venues, which may in turn be a driver of lower costs.

4.18 Data vendors may be able to charge high prices for data products because of high switching costs which exist because firms invest in training staff and adjusting their systems to operate with the data vendor's technology.

88 Oxera (2014), Pricing of market data services: An economic analysis, www.oxera.com/getattachment/33e57fa3-73c0-4462-9824-81f2bd0c77ca/Oxera-report-on-market-data.pdf.aspx?ext=.pdf [Accessed 28th November 2014].

89 Regulation National Market system is a US financial regulation passed by the SEC.

4.19 We note that both trading venues and data vendors can bundle either similar or unrelated services together. We discuss bundling in sections two and three above and note that there may be efficiency reasons for the bundling. However, it may make it difficult for clients to accurately assess whether they are getting value for money. Where the firm bundles data or services over which it has market power with services which it competes over, bundling may also serve to foreclose entry from competitors.

4.20 There are significant regulatory initiatives on-going at the European level. MiFID II and MiFIR, concluded in July 2014 and taking effect in January 2017, include provisions on unbundling of data sales, defining 'reasonable commercial basis' for data sales, and the creation of a post-trade consolidated tape. These regulatory changes may change the way competition works for these services.

Responses to the call for inputs on trading and clearing

- We received a number of responses highlighting potential competition issues in the arrangements between trading venues and CCPs. A number of respondents highlighted that there could be potential issues with vertical integration[90] between trading and clearing services. For example, one respondent argued that vertical silos restrict competition and prevent access. This restricts standalone trading venues or CCPs from offering services, as they cannot get access to clearing services or trade feeds (or cannot do so under reasonable terms). Generally, responses indicated that this issue is more relevant to derivative markets. Respondents noted that in the UK equity markets, trading venues, in general, are 'open' and users can clear trades via a number of CCPs.

- Several respondents explained that users select venues based on the instrument traded or available liquidity, and not on clearing arrangements. Therefore vertical integration may not have a significant impact on competition. However, one respondent suggested that margin efficiencies[91] drive where clients are likely to clear trades, in particular when deciding where to clear OTC trades.

- The limited fungibility of derivative instruments was also noted by respondents as a factor that limits trading on multiple venues, rather than access per se. One respondent suggested that new products should be given regulatory protections for a period of time before access is opened up – as is the case in the pharmaceutical industry. Several exchanges argued that increased competition at the trading venue level may fragment liquidity.

- In addition, some respondents suggested that increased competition between CCPs may lead to competition on risk management which could impact financial stability. For example, this may be through a reduction in margin requirements.

- Some respondents suggested that the vertical silo structure promotes innovation as products can be created more easily when CCP arrangements are able to be factored into development.

90 Vertical integration is when two firms in different stages of a supply chain merge. An example of this would the merger of a CCP with a trading venue.

91 By margin efficiency, we mean that a firm may be able to achieve a lower margin/collateral requirement for clearing multiple trades a one venue, than clearing the same number of trades at individual venues

Trading and clearing: our analysis

4.21 Vertical silos have become a common structure for clearing and settlement within the UK. For example, of the five recognised central counterparties and clearing houses,[92] all operate some form of vertical integration. In addition to vertical silos, some respondents believe that access to provide services to clearing houses that would benefit users, for example more effective collateral netting, are restricted. The CCP therefore has market power for the provision of these services.

4.22 The continued move toward a vertically integrated model appears to be due to the competition between exchanges. In particular, the derivatives markets appear to be global (and at least European) in nature. Therefore, vertical integration in the UK may be a natural response to the pressures of competing with global or European exchanges, who already benefit from the economies of scope provided by vertically integration.

4.23 There are number of potential competition issues associated with vertical silos. In particular, bundling and exploitation of market power may be issues. However, vertical integration in itself does not necessarily mean competition is not working effectively, particularly if there is competition between vertical silos.

4.24 Bundling (as discussed in sections two and three above) can occur across the transaction chain, with trading and post-trade activities being provided by the same group. Therefore, clients may not easily be able to determine the relative costs they are paying for each service. In addition, such bundling can be used to prevent entry of stand-alone providers or trading or clearing services.

4.25 Further to this, if an exchange is the only venue for a specific instrument, it may be able to exert market power and charge excessive prices.

4.26 An important factor when considering the issues around vertical silos is the existing and upcoming regulatory framework. In particular, EMIR sets out that access between CCPs and trading venues should be provided on a non-discriminatory basis for OTC derivatives. MiFIR will bring in equivalent provisions for on-venue derivatives, which seek to address the issues around vertical silos.

92 www.bankofengland.co.uk/financialstability/Pages/fmis/supervised_sys/rch.aspx

Responses to the call for inputs on client clearing

- Some respondents suggested that there may be issues related to access to clearing services. EMIR requires certain firms, including all financial counterparties, to centrally clear certain classes of OTC derivative contracts via CCPs. The majority of firms subject to EMIR will access CCPs via clearing members. These firms are direct members of CCPs.
- Specifically, a few respondents mentioned that there was limited choice for OTC clearing services in the UK. One respondent noted that two clearing members out of three in a particular segment of the market, have left the market in the last six months. Several investment banks suggested that client clearing was not a profitable business; hence why the two aforementioned firms have left the market recently. The banks indicated that they offer client clearing because clients expect the service as part of an overall package.
- Respondents generally believed that regulations, in particular the capital requirements under Basel III, are making it unsustainable for clearing members to offer clearing services. A number of respondents suggested that only the largest institutions will be able to become clearing members.
- In terms of indirect clearing[93] some market participants noted that there are significant legal and operational challenges to this model. For example, the potential for increased counterparty risk due to difficulties in monitoring the 'chain' of indirect clearing.
- One respondent noted that the market for client clearing will change markedly when client clearing obligations are introduced in 18-36 months. They stated that it is not certain how many providers there will be, not least because the ultimate scope of the clearing obligation, or which CCPs will be available for clearing, is unknown at this stage.
- A trade body explained it had received complaints from clients of clearing members who were charging monthly minimum fees to small clients or bundling clearing services with ancillary services.

Client clearing: our analysis

4.27 Client clearing is important for the effective functioning of the financial markets. We discussed the concept of missing markets in the call for inputs, whereby a genuine client need exists but nobody comes forward to supply. There appears to have been a reduction in the number of clearing members which may have the potential to develop into an example of a missing market.

4.28 The issues raised appear primarily to be in the derivatives markets, and in particular, the OTC derivative markets. Accordingly the focus of our analysis has been on this market. This is important because certain risks, such as interest rate risk, may not be transferred throughout the financial system. Among other effects, this has the potential to weaken the balance sheet of users of OTC derivatives, making them less stable and ultimately could lead to a less resilient economy.

93 A set of contractual relationships between a CCP, clearing member, client of a clearing member and that client's client, that allows the client of a clearing member to provide clearing services for its own client.

4.29 We believe at present, there is some competition for clearing services and that there is not currently a missing market, although respondents indicate that the market may be concentrated, which can result in competition issues. Although we note that certain clearing members have exited the market, we understand that at least one firm in looking to enter the market. This indicates that there are likely to be clearing services available in the immediate future.

4.30 However, as firms exit the market, the market it is becoming increasingly concentrated. Where this is the case, clearing members could exploit market power (particularly if they are the only clearing member offering services to certain market participants) for example, by enforcing minimum monthly expenditure, increasing prices, or bundling services together and requiring firms purchase all of the items in the bundle to access the necessary service.

4.31 There appears to be two main drivers behind the exit of clearing members from providing clearing services. Firstly, the additional regulatory costs associated with clearing appear to be a factor in this decision. A recent report[94] indicates that for centrally cleared OTC derivatives, there may be an additional cost of €13.60 per €1 million notional traded. Whilst these costs may appear limited, when aggregated across a business, the capital required for this activity may be more productively used for other means, leading to a decision to exit. Secondly, the delay in the implementation of mandatory OTC derivative clearing as part of EMIR may have led to certain clearing members exiting this market.

4.32 Taken together, the market appears to be in a state of flux at present. Therefore, identifying the impact of potential competition issues is challenging. For example, the exits from the market may be temporary, until mandatory clearing under EMIR comes into force. Therefore, the structure and function of the market is still being developed and the effects on competition may not be observable until EMIR implementation.

Responses to the call for inputs on co-location

- Co-location, the service usually provided (directly or indirectly) by a trading venue, to enable a firm to place its server close to a trading venue matching engine, was generally welcomed by respondents. They were of the view that the ability to co-locate has levelled the playing field for market participants requiring reduced latency. Respondents also generally agreed that co-location should be provided on a fair and transparent basis.

- A few respondents highlighted that there is potential for exploitation of market power in the future where an exchange owns a data centre. This is because co-location in a given exchange is necessary for certain market participants. Where this is the case, the exchange has a monopoly over the provision of the co-location services and can exploit this monopoly position by increasing prices.

- One respondent raised the issue of discriminatory access to co-location services, for example, they perceived access to data centres might be limited to dominant market participants.

- However, some respondents felt that the forthcoming co-location provisions in MiFID II would address both access and pricing issues.

94 www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fs-otc-derivatives-april-14.pdf

Co-location: our analysis

4.33 Many market participants will choose to be co-located in a number of (or possibly all) exchanges in Europe or globally. Each exchange has a monopoly over the space in their particular exchange and is able to charge for the co-location services, although we note that some exchanges choose to outsource the operation of the co-location services to third party data centres.

4.34 There are also a number of additional services associated with co-location that need to be purchased to make co-location a viable offering. Respondents highlighted that cabling, rack space and links between exchanges, among others, are additional services charged for by exchanges.

4.35 The main competition issue raised by respondents in relation to co-location was the ability for exchanges to exert market power over users of co-location and its associated services. This can occur as although there may be multiple exchanges in competition, if a firm wants to co-locate at a particular exchange, there is usually only one provider of this service. Competition between exchanges may regulate this power to a certain extent. For example, if a client wants to trade UK stocks there are multiple venues to undertake this activity. However, if a firm wants to connect to a specific exchange it may have no choice but to take the co-location services at the prices demanded.

4.36 Where this is the case, exchanges have the ability to increase prices; however we received mixed views on the extent to which this had happened. Some users argued that high pricing was an issue whilst others did not share the view. Our review also highlighted that in the UK, co-location services may not be provided directly by the exchange; potentially further limiting the use of monopoly power. Furthermore, we note that exchanges may benefit from providing co-location service to a large number of market participants, and this may act as a barrier to excessive pricing.

4.37 MiFID II and MiFIR are aiming to make co-location services available in a fair, transparent and non-discriminatory manner, which may address a number of the issues raised by respondents.

Other issues raised in response to our call for inputs

- Respondents also highlighted a number of more discrete issues in response to the call for inputs. A number of respondents felt that regulation, generally referring to Basel III and resulting regulation,[95] but also other issues such as the costs associated with trade reporting, are barriers to entry to markets and market infrastructure.

Other issues: our analysis

4.38 In our call for inputs, we explained that regulation can act as a barrier to entry and the FCA has also recognised that regulation can inhibit competition. For example, Project Innovate[96] has acknowledged there may be areas of our regulatory framework that need to adapt to enable further innovation in the interests of consumers.

95 Basel III is an international regulatory standard that looks to improve capital standards, liquidity and governance at banks

96 www.fca.org.uk/firms/firm-types/project-innovate

4.39 However, the regulations that have been cited by respondents as barriers to entry are global or Europe-wide in nature and have been developed to improve financial stability and transparency within the sector. One of the aims of Basel III is to improve the banking sectors ability to absorb shocks arising from financial and economic stress.[97]

4.40 We understand there are challenging dynamics between regulation and competition in these markets. For example, margin requirements at CCPs are designed to ensure that CCPs are resilient on the failure of a clearing member. If these standards are lowered, then barriers to entry may also decrease and in turn increase competition for clearing services. This may lead to lower prices for clearing services, and more choice for those requiring clearing services. However, the lowering of margin requirements could increase the risk of the failure of a CCP and financial instability, which in turn could result in higher costs to end users. The above example highlights the complex interaction between the risks that regulation looks to mitigate and ensuring there is adequate competition within the market.

Suitability for a market study

4.41 Based on the responses received and our initial analysis, we consider that there are areas where competition may not be working effectively in relation to markets and market infrastructure. The following areas may benefit from further investigation through a market study:

- Data – the extent to which data and licenses are provided on a fair, reasonable and transparent basis.
- CCPs and trading venues –the effect of the vertical silo model on competition and, in particular, whether stand-alone providers can compete effectively.
- Client clearing –whether all market participants who require clearing services able to obtain them on a fair, reasonable and transparent basis.
- Co-location –whether co-location services being provided on a fair, reasonable and transparent basis.

4.42 When assessing these topics against our prioritisation criteria, we do not think they are prime candidates for a market study at this stage, although we may consider them as candidates for future market studies.

4.43 A significant driver of our decision not to undertake a market study in this area at this time is the degree of regulatory change on-going in relation to markets and market infrastructure. There appears to be significant cross-over with the competition issues raised by respondents and the European legislation currently being implemented.

4.44 In particular, the key pieces of legislation affecting markets and market infrastructure are MiFID II/MiFIR[98] and EMIR.[99] These pieces of legislation set out to address, or at least are likely to impact, the competition issues that participants have suggested. We have been involved in the development of these pieces of legislation and continue to be involved in their implementation.

97 www.bis.org/bcbs/basel3.htm

98 Directive on markets in financial instruments and the Regulation on markets in financial instruments (http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm)

99 European Markets Infrastructure Regulation (http://ec.europa.eu/finance/financial-markets/derivatives/index_en.htm)

4.45 We recognise that the forthcoming regulation may not address all of the competition concerns raised. However, the regulatory changes are likely to have a significant impact on the markets concerned and may well affect how competition works within them. A number of respondents supported this view and argued that it was not the correct time to examine certain markets/issues.

4.46 Our research indicated that competition for a number of markets and market infrastructure related services exists at a European level or a global level. Some respondents highlighted competition issues that exist within Europe that we may not be able to effectively address at a UK level, for example, issues with data at other European exchanges. Competition at a global or European level would not prevent us from looking at issues. In some cases, we may be able to make improvements to the way competition works in the UK, which would improve the competitiveness of markets and market infrastructure providers in the UK and benefit consumers. However, we recognise that in some cases, it may be necessary to address the issues raised at either a European level or global.

4.47 There are certain elements of market infrastructure that were referred to by respondents that are not directly regulated by the FCA. For example, the Bank of England is responsible for, amongst other things, the oversight of central CCPs, and settlement and payment systems and the potential impact of intervening in these cases may be reduced.

4.48 When looking to identify a candidate for a market study, we have taken into account the on-going work within the FCA which is examining some of the issues raised. For example, in relation to markets and market infrastructure, work is on-going looking at high-frequency trading, dark pools, OTC derivative reform, trade/market data and benchmarks. Therefore, we are continuing to monitor developments, and examine potential competition issues as part of this work

4.49 The Fair and Effective Markets Review[100] is looking into market infrastructure in the FICC markets. The outcome of this review may also inform whether competition issues exist in aspects of markets and market infrastructure, and we may consider further investigation of these issues.

4.50 As stated earlier, we recognise there are potential aspects of markets and market infrastructure in which competition issues may exist and we may consider these for future market studies. We will continue to monitor implementation of changes in the market and would welcome on-going input if new competition issues emerge or the issues highlighted improve or worsen.

100 Bank of England, FCA, and HM Treasury, Fair and Effective Markets Review, Available at: www.bankofengland.co.uk/markets/Pages/fmreview.aspx.

5.
Other topics raised by respondents

Summary:

- We received additional responses which raised concerns about;
  - Treasury management advisers and the advice they provide to public sector local authorities;
  - Platforms in the asset management industry; and
  - High pay within the financial sector.
- We have considered these topics against our prioritisation principles, and do not currently think that they would be suitable topics for a market study.

Responses to the call for inputs on treasury management advisors

- One respondent suggested that there were potential competition issues in the market for Treasury Management Advisor Services (TMAS) provided to local authorities. The respondent suggested that one firm has a large share of the market for the provision of TMAS services to local authorities.
- The respondent suggested that the TMAS provider can prevent challenger banks from being placed on an approved counter-party list which means they cannot access local authority deposits, preventing them from achieving scale. Another respondent suggested that traditionally many building societies took significant deposits from local authorities, however following the financial crisis there has been a greater emphasis on credit ratings which has prevented access to local authority deposits.
- A respondent argued that the advice offered by TMAS firms may be of poor quality. They also noted that there may be conflicts of interest with other areas of the TMAS firm's wider business such as broking or outsourcing. The respondent suggested that the Chinese walls in place may be insufficient to address these concerns.

Our comments:

5.1 We note that there are changes in MiFID II which may address some of the concerns raised in relation to the quality of service provided by TMAS firms. Therefore, we have decided not to select TMAS for a wholesale market study.

5.2 Under MiFID II, local public authorities will be, by default, retail clients. This should afford public sector bodies more protection when dealing with TMAS firms. However, as with all clients, they will still be able to request to be treated as a professional client. We may wish to consider the extent to which local public authorities are choosing to opt-up to professional status and what impact this has on the quality or type of advice they receive as a result through future industry engagement.

5.3 We would also be interested in receiving views on the reasons why challenger firms are not on the approved counter-party list and the extent to which this is driven by local authority clients as opposed to the TMAS provider.

Responses to the call for inputs on platforms

- We received several responses referring to the changes in the market for fund management and platforms, following the introduction of the Retail Distribution Review (RDR).[101]
- Many of these made reference to the changing nature of the platforms market. For example, one respondent argued that because asset managers are unable to pay platforms an element of their AMC, platforms are now less willing to host smaller funds as they cannot confirm that their costs will be met.

Our comments:

5.4 Most of the comments received in relation to platforms relate to the retail space, and therefore would not fall within the scope of this review. However, we are continuing to monitor developments in relation to platforms (particularly following the implementation of RDR[102]) as part of our ongoing policy work.

101 Further information about RDR www.fca.org.uk/firms/firm-types/sole-advisers/rdr

102 The RDR post implementation review, commissioned by the FCA is available at: www.fca.org.uk/static/documents/research/rdr-post-implementation-review-europe-economics.pdf

Responses to the call for inputs on high pay

- We received one response on the issue of high pay within the financial sector and the implications that this has on competition within the wholesale market.
- In particular, the respondent argued that the recent manipulation of key benchmarks, such as LIBOR, demonstrates that employees within the sector are incentivised to make decisions which cause detriment to the effectiveness of competition within the industry. The respondent also noted that in wholesale markets there is substantially less transparency than in retail markets, so it may be easier for market participants to engage in misconduct.
- The response does not suggest a specific topic for a market study, but rather considers that the concerns raised in relation to high pay may be relevant across many wholesale sectors.

Our comments:

5.5 We consider that financial incentives may have an impact on the way that competition works within a given market, and may consider this further when undertaking any market study in the wholesale sector.

5.6 We are also undertaking policy work into remuneration more generally and we continue to be active in European level work in this area and note that this response does not propose a specific issue that would form the basis for a market study.

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