Financial Conduct Authority

Wholesale sector competition review: Feedback from roundtables

As part of the wholesale sector competition review, we held five round table meetings between July and October 2014 to gather initial views on the topics raised in the call for inputs.

We did not express a view on the issues raised during discussion as the round-tables were intended to seek industry feedback. Building on this feedback, we expect to announce work to be taken forward in Q1 2014.

The agendas for the roundtables included the areas highlighted in the relevant section of the call for inputs and other issues raised by attendees.

This document sets out a summary of the key points raised in the round tables, which covered topics in asset management, investment and corporate banking and markets and market infrastructure. These views summarised below expressed by at least one attendee (and others who attended might not share these views).

Asset management

We held two round-table meetings to discuss whether competition is working effectively in the wholesale sector of asset management. Attendees included representatives from asset management firms, custody banks, trade associations and consultancy firms. We discussed:

- Incentives for asset managers when negotiating for investors
- The bundling of ancillary services
- The differences in charges between retail and institutional funds
- Other competition issues (including the role of investment consultants and the provision of data services)

Key points raised by attendees:

- Whether sufficient incentives exist for asset managers to negotiate the best deal for investors:
    - In addition to the fiduciary responsibility asset managers are incentivised to maximise fund performance as it is a key driver of assets under management and hence revenues. Maximising fund performance includes effective negotiation to secure good value for any services charged to the fund.
    - The quality and reliability of services purchased for a fund are important considerations so the best choice may not always be the lowest cost option.

- Whether bundling of ancillary services provided to asset managers is in the interest of investors:
    - Bundling of ancillary services provided to asset management firms and investment funds can be beneficial due to cost savings and reduced operational

complexity. In many situations, any cost savings from bundling are often passed on to clients.
    - Bundling of ancillary services could in theory make it more difficult for new market entrants providing standalone services. However, some providers of standalone services are successful and the quality and value of ancillary services in a bundle is generally good.
    - Transparency of charges for bundled services has improved over the past few years.

- Reasons for the differences in charges between retail and institutional funds:
    - The primary reason that retail fund charges are higher than institutional funds charges is the higher costs associated with running retail funds, for example due to the greater administrative requirements for retail funds.
    - Institutional clients with the potential to make very large investments have stronger negotiating positions which can be used to reduce fee levels.

- Other topics discussed:
    - The participants had mixed views about whether or not investment consultants add significant value in the investment decision-making process. One participant commented that there is a lack of competition for investment consultant services and that the services are high cost relative to the value provided. Another participant disagreed commenting that despite the concentrated nature of the market, there was a high degree of competition between investment consultants and that the investment consultant service is highly valued by pension trustees. The participant added that this is particularly the case where investment trustees do not have extensive experience of the investment market.
    - It is difficult for asset management firms to change provider for some types of data. This can lead to a lack of competition after an asset manager has selected a data provider, for example for the provider of a benchmark for a fund.

Investment banking and corporate banking

We held one round-table meeting to discuss whether competition is working effectively in investment banking and corporate banking. Attendees included representatives from investment banks, commercial banks, consultancy firms, independent service providers and trade associations. We discussed:

- Cross-selling and bundling of investment banking services (including corporate access)
- Debt and equity capital markets
- Best execution
- Corporate banking

Key points raised by attendees:

- Whether bundling of investment banking services distorts competition:
    - A number of participants commented that companies have a wide choice of investment banks for all services and that there is a high level of competition. They also added that provision of one service (such as corporate lending) does not put an investment bank in an unassailable position to win other business.
    - For secondary equity issuance, a corporate client benefits from an investment bank understanding its shareholder base. The corporate therefore often selects

the corporate brokers for ECM transactions (as previous corporate broking activity gives the corporate broker a good understanding of the shareholder base).
  - A number of participants commented that the various services required to conduct an IPO are sold in a bundle but corporate clients understand the range of services provided and the fee is clear. In this regard, investment banks are transparent in their pricing for services and the market for IPO services is very competitive.
  - One participant commented that IPOs are priced very similarly to rights issues, although IPOs involve proportionally more work. The reason for this is that investment banks expect future benefits from underwriting IPOs, such as commission revenues from asset managers from secondary trading of shares. This was not considered to be a competition concern.
  - Participants disagreed about whether there is a lack of competition in the service provided to publicly listed companies (PLCs) to co-ordinate and advise on the interaction of the PLC executives with its shareholders and other asset managers (corporate access). One participant commented that there is a lack of competition due to the corporate broking model where this service is typically provided for free to large corporates and that this has led to a low level of innovation. This participant also noted the conflict of interest when an investment bank advises the senior management of a PLC about which asset managers to meet and also receives secondary dealing commissions from these asset managers. Other participants commented that this conflict of interest is not a concern as the PLC senior management would not agree to meet any asset managers if it was not in their best interest. These participants also commented that the service provided is good and disagreed that there is a lack of innovation.

- Debt and equity capital markets
  - Corporates typically rotate the lead firm in DCM transactions. This incentivises investment banks to provide a good service in order to get future business and promotes competition.
  - The provision of corporate lending is often by the same banks involved in DCM transactions, although there is no formal tie. The provision of ECM services is typically considered separately to DCM work, with different investment banks often involved.

- Best execution
  - Best execution is relatively easy to monitor in liquid equity markets. In other areas, such as some of the more illiquid fixed income markets, monitoring of best execution is more difficult.
  - The participants noted that the best execution requirement is not entirely focused on price and that some of the other aspects of best execution are more difficult to monitor.
  - MiFID II will introduce more pre-trade transparency in some markets which should help clients monitor best execution.

- Corporate banking
  - The provision of loans to corporates is very competitive.
  - Corporates face significant cost and operational risk when switching banks for some services, such as cash management. Many larger corporates would tend

to maintain more than one corporate banking relationship to encourage competition but this is not necessarily practice for small firms.

Markets and market infrastructure

We held two round-table meetings to discuss competition related to markets and market infrastructure. Attendees included representatives from investment banks, trading venues and trade associations. We discussed:

- Arrangements between trading venues and clearing houses in both OTC and venue-traded markets
- Packaging of trading and clearing services by dealers in the OTC and venue traded markets
- Client clearing
- Concentration of trading in OTC and venue traded markets
- Co-location of firm servers
- Production and dissemination of data

Key points raised by attendees:

- Arrangements between trading venues and clearing houses in both OTC and venue-traded markets
    - A number of participants suggested that fungibility of derivative contracts was the key limiting factor for the opening up of clearing. One participant suggested that while it was important for regulatory protections to be given to new products to allow them time to build up and to earn rents (otherwise there would be no innovation), access should be opened up after a time – as it is in the pharmaceuticals industry. There was a debate between participants over the extent to which contracts could be made fungible. Some participants suggested that for some more specialised contracts, it was useful to have the liquidity in one contract, and there might be adverse consequences to opening it up to other providers (e.g., price determination across markets could be difficult). Others considered that competition should be opened up.
    - Participants suggested that it was possible for fees to be rebalanced up and down the transaction chain, for example between trading and clearing, or from clearing to settlement. One participant suggested that bundling of prices should be avoided from a competition point of view.
    - Participants also suggested competition is global, so this needed to be taken into account when considering whether and how to apply any rules.

- Packaging of trading and clearing services by dealers in OTC and venue traded markets
    - Participants noted that there is little profit to be made clearing OTC derivatives as a standalone business in the current market. There were a number of other factors associated with offering a clearing service, including the amount of capital required, possible financial impacts on the firm, the ability to participate in the default management process/operational capabilities, and the relationships that are needed. It was suggested that firms typically need a trading business to hedge the exposures of the derivatives they are clearing.
    - Given the above, some participants suggested clearing is often included as part of a package of products and that there was client demand for clearing being included as part of firm offerings. While this might lead to some cross-subsidisation of services, participants considered that it was not the intention to offer clearing as a loss

leader, and there were various ways in which businesses can develop relationships with/offer packages to clients.

- Client clearing
  - A number of participants suggested that there was a natural limit on the number of clearing members, to around 10-12 firms, due in particular to risk management requirements (including regulatory requirements) and the relationships that are needed. A lot of infrastructure is also required, in terms of operations, IT etc. Attendees noted that clearing members do not want to take on the risk of a 'weaker' member due to the responsibilities to share costs of member defaults.

- Concentration – venue traded markets
  - Different views were expressed. For example, it was suggested that the auction process on primary markets concentrates transactions on that venue, and that the way in which the process operated was detrimental to price formation.
  - However, other participants suggested that there are a number of benefits from liquidity being concentrated in one/a small number of markets –e.g., easier and less costly to locate other counterparties and prices. Other participants suggested that there may be an appropriate balance to be had between ensuring sufficient liquidity versus the level of concentration in the market.

- Concentration – OTC markets
  - Some participants did not feel the lower level of transparency in the OTC markets gave rise to competition issues. They felt that OTC markets offer a number of important benefits over venue traded markets, and it was not always the case that pricing behaviour was inferior. Clients are often connected to multiple dealers so that they can request quotes quickly, and in some cases, spreads in OTC markets are lower than on some venues.

- Co-location
  - Most participants did not feel that co-location was an issue in terms of capacity or cost of access.
  - Participants suggested it was in the interests of venues to attract clients to co-locate as it increases liquidity and network effects. This provides a driver for venues to keep prices down.
  - One participant noted that their experience was that costs are based on the requirements of clients in terms of infrastructure, rather than the amount of liquidity they could bring (i.e., venues sought to cater for all clients rather than giving preferential treatment to some).
  - It was suggested that a future issue to monitor was data centres owned by trading venues, as opposed to third-party owned data centres. In the former case, where venues have control over the charging structure, it was suggested that an issue could potentially arise whereby such firms seek to apply excessive charges once they have built up a dominant market position.

- Production and dissemination of data
  - Some participants were of the view that the market data is expensive. Some participants noted that the data costs charged by venues are just one part of the chain, with vendor costs making up a large part of the overall cost paid by end users/venue costs being a relatively small component. Some participants suggested that the chain should be considered as a whole because of this. However, others took the view that these costs were separable and could be considered as such, and

suggested that there were differences in the degree of competition between vendors (mixed views were expressed relating to the degree of competition between vendors – some thought competition was quite good, while others pointed to infrastructure costs involved in switching) and venues.

- It was suggested that there was currently some bundling and cross subsidisation in market data provision, but that EU/Global regulatory changes would have an impact on market data provision in the future. Some participants suggested that it would be important to consider the market from an international perspective so as not to detrimentally impact UK competitiveness. Attendees noted that it would be important to see how ESMA proposals regarding, for example, Reasonable Commercial Basis, would work in practice.