

ASIA IRP Submission to ASIC

Who are we?

ASIA IRP is an industry association representing the interests of Independent Research in the Asia Pacific region. Our members include independent research firms and brokers based in Asia and Australia. Working in conjunction with our sister organisations, Investorside in the U.S. and Euro IRP in Europe, one of our core goals is to raise awareness of conflict-free research as an important tool in investment decision-making. We believe that the best outcome for end investors is achieved within a framework of best of breed research combined with best execution, and that this requires transparent and efficient mechanisms to enable payments for independent research.

Why are we writing to you?

The current Consultation Paper¹⁴⁵ relating to Australian equity market structure directly addresses the implementation of best execution regulation for market participants: paragraph 20(c) requests feedback on issues requiring further consideration; paragraph 100 Table 7 (Persons in scope) also requests feedback on expanding the scope of the proposals to intermediaries such as fund managers.

1. Asia IRP would like to raise the issue of unbundled and transparent payment for research as an integral component of effective best execution, as well as a key driver for the development of un-conflicted research in Australia.
2. We would also encourage ASIC to review the role of fund management firms in the implementation of these proposals in order to ensure that the best outcome for the end investors is achieved and considered.

Summary of Asia IRP feedback

1) Clearer guidance required on unbundling to achieve best execution and create a level playing field for independent research – with specific reference to question G1Q8 of CP145

We believe that - as evidenced in other markets which have adopted best execution regulation, such as the UK and Europe– the unbundling of payments for research and trading is essential for successful implementation of best execution. It also helps create a level playing field for the payment of independent research and minimises conflict in the provision of all types of investment research. ***We would therefore encourage ASIC to more clearly incorporate guidance on unbundling into current proposals on market structure, with specific reference to the best execution requirements of Section G.***

The business model of many Australian market participants currently bundles together the choice of executing broker with the provision of research without a clear distinction between the value and the payment of each service individually. Greenwich Associates estimates that for international investors trading Australian equities, over 62% of execution payments are allocated to a broker to pay for research and advisory services rather than purely on the basis of the broker's execution quality.

We suggest that incorporating clear guidance on unbundling and the use of Commission Sharing Arrangements (CSAs) into current proposals would benefit market integrity and the implementation of best execution regulation.

Proposals:

- a) **Incorporate specific wording into best execution regulation to ensure the decision about execution tool/broker is made in its own right under the provisions of best execution.** Decisions about payments to cover research commitments or other broker-provided services should be made separately in a transparent and unbundled manner.
- b) **Refer in regulation to the implementation and use of Commission Sharing Arrangements to manage unbundled payments.** This could extend to mandating a responsibility by market participants to offer CSA structures to clients on request, so that payment to independent research firms can be made by any investor, through any broker of their choice. We would be strong supporters of a wording in the regulation that would make brokers duty bound to Commission Sharing Arrangements should it be requested.

2) *Expand the scope of the proposals to include responsibilities for fund managers – with particular reference to question G1Q8.* *From the perspective of Asia IRP, we will limit our comments in this area to requirements around selection of market participant, unbundling and payment for research.*

We understand the proposed regulation aims to improve competition and drive cost reductions and efficiencies for both institutional and retail clients. We believe that unbundling the choice of research provider from execution provider is a vital component to achieve these benefits (see below section for further detail). In the context of best execution, while market participants can choose which market is most appropriate as an ultimate execution venue, they do not have any control over cost factors further upstream which the fund manager controls. In particular this includes the selection of the market participant to deliver best execution. Ultimately it is the fund manager's responsibility to choose an appropriate provider to deliver best execution for their investors; in a bundled environment the need to pay for research using execution may reduce the level of choice or blur boundaries, undermining the proposed end outcome of lower overall costs, costs ultimately borne by the investor.

We would support a structure under which elements of best execution responsibility are applied to fund managers. IFSA guidance note 10.00 already offers a voluntary framework for governance for Australian fund managers in the management of dealing commissions. However Asia IRP member firms' experiences in other markets has shown that specific regulation has a far more immediate and distinct effect on behaviour. For example the UK FSA's approach to regulation of fund managers in respect of dealing commissions was deemed to have had the following effects (Page 8 of a report by Oxera called 'the impact of the new regime for use of dealing commission: post implementation review'

http://www.fsa.gov.uk/pubs/other/oxera_dealing_commission.pdf:

This section reports on relevant changes in market practice that have occurred:

- the use of CSAs has gone up—the proportion of fund managers with CSAs has increased from around 50% to more than 70%;
- more providers are paid from CSAs—from an average of just under 20 to over 40 providers per investment manager with a CSA;
- expenditure through CSAs has increased, as has the proportion of that expenditure going to third parties.

Why is unbundling of research and execution important?

- **Enables fund managers to seek true best execution:** CSAs enable clients to deal with the broker of choice at the point of execution, empowering trading desks to focus on best execution whilst still enabling the fund managers to pay for research services from diverse providers, including independent research providers. In a multi-provider environment such as the current Australian market, brokers have different degrees of sophistication in the areas of research and separately, execution. These differences will only be exacerbated by the technology and compliance requirements of the proposed best execution regulation.
- **Offers payment options for those providing quality research but unable to invest to meet new best execution requirements:** As ASIC implements more rigorous best execution requirements on market participants, smaller brokers who had previously provided quality research and been paid through execution, but who may not be able to invest sufficiently to meet new best execution regulation, will still have a mechanism to get paid for quality research product.
- **Incentivizes independent research companies to contribute to the markets through efficient payment systems** as ASIC implements more rigorous best execution requirements on market participants, smaller brokers who had previously provided quality research and been paid through execution, but who may not be able to invest sufficiently to meet new best execution regulation, will still have a mechanism to get paid for quality research product.
- **Reduces conflict of interest in research:** we believe that research can be independent only when developed solely to support successful investment decisions – not as a tool to sell a particular firm's securities or other services. As a result of a decision being made about the value of the research independent of other services a broker may offer, fund managers should be better able to judge whether value-for-money is being achieved when purchasing research using their client's commissions than is possible in a bundled environment. It also creates a more level playing field to allow the development of, and payment for, valuable independent research.
- **Increases competition in the provision of execution services.** As a result of the discrete pricing of execution (without bundling in of non-execution services such as research), and the removal of guaranteed business levels associated with bundled arrangements, there should be heightened price and service competition in execution than in a bundled environment. This trend is supported by ongoing drops in broker commission rates in

markets where CSAs are prevalent (further information about average commission rate distribution in different global markets can be found at: http://www.itg.com/wp-content/uploads/2009/12/ITGGlobalCostReview_2010Q2_Final.pdf)

Asia IRP believes that ASIC now has a unique opportunity to develop the scope of best execution regulation to incorporate guidance on unbundling which will:

- Improve transparency and conflicts of interest around payments for research
- Level the playing field for payment of best of breed research, separate from best of breed execution
- Benefit end investors through increased competition and transparency of payments for both research and trading

We would be happy to discuss these suggestions further,

Edward Stockreisser, Co-Chair, Asia IRP, on behalf of:

Founding Members

Responsible Research

Responsible Research is the leading provider of quality independent Environmental, Social, and Governance research in Asia for global institutional investors. Their approach is based on analysis of material ESG factors, which increasingly affect both investment decisions and sustainability in the region. Responsible Research develops and sells portfolio management tools such as the Asian Sustainability Rating™ and RepRisk® which can be used alongside their sectoral and thematic monthly reports.

Lombard Street Research

Lombard Street provides accurate economic forecasts in order to improve the investment thinking and strategic decisions of financial institutions, banks and corporations worldwide. The company boasts some of the most original, rigorous and consistently accurate comment and analysis on the world's markets.

Asianomics

Asianomics Limited is an independent economic research company providing insights and analysis of policymaking and macroeconomic trends across all Asian economies. The company places particular emphasis on the credit and profit cycles which are fundamental to successful investing in any market.

DSG Asia

DSG Asia provides independent, strategic analysis and risk assessments of the economic and political environment in the major countries of Asia - primarily Japan, Greater China, the Koreas, ASEAN and the Indian subcontinent.

ISS

ISS is the leading provider of corporate governance solutions to the global financial community. More than 1,700 clients rely on ISS' expertise to help them make more informed investment decisions on behalf of the owners of companies. ISS' services include objective governance research and analysis, end-to-end proxy voting and distribution solutions, turnkey securities class-action claims management, and reliable governance data and modeling tools.

ISS is part of MSCI Barra. The MSCI Barra group delivers world-class, mission-critical investment decision support tools to a broad variety of financial institutions worldwide.

APPENDICES:

Supporting data and examples from other markets

Below is a short summary of the regulatory background in the US & Europe which may be relevant when reviewing this topic:

Poor investment returns for investors following the bursting of the tech bubble, the resulting Spitzer investigation in the US, and the Myners Report on the responsibilities of institutional investors in the UK, have focused attention on the need for unbiased investment research and the role which independent providers can play. Historically, research was perceived as 'free', i.e. bundled with execution services by the investment banks. Not only did this give rise to many recognized conflicts of interest, but it also made it extremely difficult for independent research providers to compete - they had to recover the costs of their activities while the research divisions of banks could, and did, cross-subsidise their research from other activities, primarily execution.

In the US, the settlement negotiated by Elliott Spitzer included provisions to subsidise for a limited period the development of independent research.

The UK debate began from broader problems of cross-subsidy from client commission and in particular the question of allocating 'soft commissions'. The FSA, following the Myners Report, expressed unease that *'...payment for a transactional event is used to pay for other goods and services that need not have any direct connection with that event. This practice lacks transparency and creates conflicts of interest for fund managers in their relationships with clients and brokers...'* The major investment banks strongly resisted moves towards such transparency, arguing that the transaction value chain could not be broken down into identifiable separate segments. But the FSA insisted on narrower definitions of services which might be accepted as part of soft commission arrangements and enhanced disclosure of the components of commission payments.

Based on the issues and recommendations in both the US and the UK, a mechanism called a Commission Sharing Arrangement (CSA) in the UK or Client Commission Arrangement (CCA) in the US has been approved and is now in common use as a method to provide transparency and accountability for payments for research, unbundled from payments for execution. On both sides of the Atlantic, the objective has been to bring accountability to the use of soft commissions or bundled research, while clarifying the acceptability of independent research as an appropriate use of client commissions.

A more detailed summary of the goals, and successes of the FSA's implementation of a regime to govern dealing commissions can be found at: http://www.fsa.gov.uk/pubs/other/oxera_dealing_commission.pdf

(It is worth noting that a concern has been raised about the introduction of CSAs resulting in a concentration of brokers used, and that this could be a particular issue given the size of the Australian market. However, the Oxera study found that this did not materialize as an effect of the new regime in the UK. Asia IRP, as an Association believes in added competition within both the execution market and the independent research market, with the goal of reduced costs for execution and quality conflict free research.