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FCA AMENDS USE OF DEALING COMMISSION RULES

FINANCIAL SERVICES REGULATION

The Financial Conduct Authority (FCA) has published a policy statement[1] containing its final rule changes on the use of dealing commission. The amendments come into force on 2 June 2014 and substantially reflect the changes on which the FCA consulted. While the FCA states that the changes simply serve to clarify existing rules, investment managers and brokers may find that the detail of the rules does not necessarily reflect current practices and should review their internal policies and procedures accordingly. In particular, the amendments make clear that firms may not use dealing commission to pay for access to senior staff at investee firms (corporate access) and also clarify which costs firms can pass on to their clients through dealing commission, including specific guidance on mixed-use assessments, where substantive research (which may be paid for from dealing commission) is bundled together with ineligible services (that firms cannot pay for using dealing commission).

Reflecting the general push by the FCA to ensure firms put the interests of their customers first, the FCA believes that the changes may result in a reduction of costs passed on to a customer's fund and an improvement in transparency of an investor's dealing commission costs.

> *"We want to ensure investment managers seek to control costs passed onto their customers with as much rigour as they pursue investment returns."* [2]

Changes at a glance

In brief, the amendments to the rules set out in the policy statement will:

- define corporate access and add it to the list of examples of goods and services that relate to the execution of trades or the provision of research that are not exempt, and so cannot be paid from dealing commission;
- provide that where services are received by the investment manager which comprise substantive research together with elements that are not substantive research, the investment manager must disaggregate any such goods or services received to ensure that only the substantive research elements are charged to the client;
- clarify the meaning of research by referring instead to "substantive research";
- clarify the perimeter of the regime by introducing a presumption of the breach of the rules if specified criteria are not met; and
- reiterate that an investment manager must have regard to its duties under the client's best interests rule when considering passing on any charges to its customer.

[1] PS14/7, which follows its November 2013 consultation on the use of dealing commission, CP13/17.

[2] FCA PS14/7, paragraph 1.7.

BACKGROUND

The current FCA rules in relation to the use of dealing commission are contained in its Conduct of Business sourcebook (COBS), at COBS 11.6. The regulator's concerns about the application of the use of dealing commission rules stem back to a thematic review in 2012 which was followed by a related "Dear CEO Letter". In its thematic work, the Financial Services Authority (FSA) identified problems with the use of dealing commissions for the purchase of market data services; corporate access; and preferential access to IPOs. In relation to the acquisition of research in return for client dealing commissions, the FSA found that the majority of investment managers had inadequate controls and oversight and were unable to demonstrate how items of research met the existing exemption under the dealing commission rules and were in the best interests of their customers.

The FCA is concerned that the use of dealing commission for these purposes leads to a potential conflict of interest, risk of harm to consumers, undermines market integrity and could also lead to investment managers competing unfairly in circumstances where the cost of purchasing such services should be funded by the investment manager itself and not out of commissions.

PERMITTED USE OF DEALING COMMISSION

The use of dealing commission to purchase goods or services is generally prohibited unless the exemption set out in COBS 11.6.3R applies. The FCA amendments seem to tighten the exemption in COBS 11.6.3R by:

- requiring that the investment manager has *reasonable grounds* to be satisfied that the goods or services purchased will reasonably assist the manager in the provision of its services to the relevant customer; and
- specifying that the good or service must be *directly* related to the execution of trades on behalf of the manager's customers or amount to the provision of *substantive research*.

In response to feedback, the FCA argues that it does not consider the introduction of a requirement that the investment manager has "*reasonable grounds* to be satisfied that the goods or services purchased will reasonably assist the manager in the provision of its services to the relevant customer" as an alteration of the burden of proof. The FCA believes that this "clarification" should not be a significant departure from the standards already in place at a compliant firm.

COBS 11.6.5E is amended to provide further clarification on the meaning of "substantive research" and is changed from a list of cumulative criteria from which reasonable grounds may be inferred to a list of criteria required for the exemption to apply with

a presumption of contravention if the criteria are not satisfied. While the FCA confirms that these criteria remain evidential provisions in the Handbook and as such there may be occasions where a good or service may be considered to be substantive research but not fall within the strict wording of COBS 11.6.5E, the FCA does not expect this departure to occur frequently.

In its feedback, the FCA indicates that substantive research does not require a particular format or require that the manager agrees with the research or reaches a buy or a sell conclusion as a result of it. However, the FCA does expect the rules to be interpreted purposively and in the best interests of a manager's customer. Therefore, a report will not become classified as substantive research merely because it has an artificial conclusion added to it. Equally, if an investment manager receives research that will never be used at all, even if it could meet the criteria for substantive research, this would not "reasonably assist" the manager.

In an additional provision, the FCA reiterates that firms passing on charges to customers under the exemption in COBS 11.6.3R(3) must have regard to the client's best interests rule and, in particular, must not charge the customer more for permitted goods or services than the cost being charged by the provider of the substantive research[3].

For the time being at least, the FCA has stopped short of prohibiting wholesale the payment for any research out of client commissions – a stance feared by industry. However, the FCA has stated that it intends to consider the need for wider reform within this area, including as part of its assessment of reforms necessitated by MiFID II.

CORPORATE ACCESS

In its 2012 paper on conflicts of interest[4], the FSA identified the use of dealing commission for gaining corporate access as an area of concern – expressly, there is a lack of transparency in the costs to consumers and a risk of the investment manager using brokers with corporate access rather than selecting a broker offering the best terms of execution for the client. The FSA said that no firm could justify classifying payment for corporate access as "research"; in particular, corporate access in itself is unlikely to offer any form of critical analysis, as required under the COBS 11.6.5E(1) exemption.

This has been an area of heightened controversy. Available data estimates that 38 per cent of the buy-side deems access to corporate boards very important when deciding who to use for sell-side research and advisory services. Demonstrating the size of the issue, the FCA also estimates that up to £500m was paid for corporate access from client dealing commissions in 2012.

Following the same line as its proposed rule changes, it is no surprise that the FCA remains clear that "corporate access services" are not to be considered research and must not be paid for with dealing commission[5]. "Corporate access services" are defined as the services of arranging or bringing about contact between an investment manager and an issuer or potential issuer. The FCA does not object to "hard" payment for corporate access by investment managers (that is, out of their own resources). However, it does object to corporate access being paid for out of dealing commission.

MIXED-USE ASSESSMENTS

Where corporate access (or any other ineligible service) is provided to a manager alongside substantive research (for example, a briefing note or research analysis input before a meeting), whether in a priced bundled or in unpriced bundled goods or services, the FCA makes a new rule that this additional substantive research should be apportioned and paid for separately, using an honest and fair mixed-use assessment[6]. Elements which do not fall within "substantive research" must then be paid for by means other than dealing commission, such as the firm's own resources. In response to feedback received, the FCA has supplemented the rules it consulted on in CP13/17 to provide additional guidance on mixed-use assessments for unpriced bundled services.

Although some respondents to the FCA's consultation requested that the FCA provide a common methodology for carrying out a mixed-use assessment, the FCA has declined to provide this. Instead, the FCA states that:

- the investment manager should make a fair assessment of the charge that the manager can apportion to substantive research;
- in carrying out this fair assessment, firms may consider making a fact-based analysis, using reasonable proxies such as comparable, priced goods or services available elsewhere in the market, or making an estimate of what their own costs would be in providing a similar good or service internally;
- a manager may find it useful to assess how much they would be prepared to pay themselves for the ineligible elements of the package in order to avoid charging the customer for elements that benefit the manager; and

[3] COBS 11.6.8AG(1).
[4] 'Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks', November 2012.
[5] COBS 11.6.8G(4A).
[6] COBS11.6.8AG.

- a firm should, at all times, have regard to its duties under the client's best interests rule and, where it is in a position to negotiate or dictate the price of substantive research, it should act honestly, fairly and professionally.

Therefore, in its assessment of eligibility of substantive research and the amount to be paid for it from dealing commissions, it will be important for a firm to be able to evidence to the FCA that it has a clear, rational process for its mixed-use assessments, with a central focus on the customer's best interest.

The FCA expects to see a convergence of market practices in mixed-use assessments, which it encourages trade associations to foster among their members.

RECORD KEEPING

A new provision reminds firms of their obligation to keep proper records of the basis on which it relies on the substantive research exemption for the use of dealing commission[7]. Indeed, in its feedback[8], the FCA repeats a message from its 2005 consultation[9] on the first version of the use of dealing commission rules:

> *"For all research services, investment managers should be able to justify, both to ourselves and to their clients, their decision to acquire a particular service with dealing commission and why it is a research service."*

[7] COBS 11.6.20G.
[8] PS14/7, paragraph 2.5.
[9] FSA CP05/5 on Bundled brokerage and soft commission (March 2005).

Action points

The changes described above come into effect on 2 June 2014.

The changes are considered by the FCA to be only a clarification of existing obligations. However, firms would nevertheless be well-advised to:

- review their practices and procedures in light of the amended rules and prevailing regulatory expectations;
- review relevant systems and controls to ensure that they remain "fit for purpose" in light of current regulatory expectations;
- re-visit commercial agreements in order to make provision for the required disclosures and transparency necessary to assist in an evaluation of what is substantive research and what is not;
- seek an informative breakdown of costs from counterparties in commercial agreements going forward;
- request assurances from counterparties that dealing commissions are only used to fund substantive research;
- create and regularly review a mixed-use assessment policy and ensure any application of this policy is carefully documented and retained;
- consider updating compliance monitoring and internal audit plans to reflect raised FCA expectations;
- consider "refresher" training for relevant personnel; and
- consider periodic communications to brokers, outlining the firm's stance/expectations.

CONTACT DETAILS

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