The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

INVESTMENT COMPANY INSTITUTE

MEMO# 27775

December 16, 2013

Member Call on UK FCA Consultation on the Use of Dealing Commission - December 20, 11 AM EST

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TO: SEC RULES COMMITTEE No. 50-13
EQUITY MARKETS ADVISORY COMMITTEE No. 25-13
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 38-13
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 34-13
INTERNATIONAL COMMITTEE No. 30-13 RE: MEMBER CALL ON UK FCA CONSULTATION ON THE USE OF DEALING COMMISSION - DECEMBER 20, 11 AM EST

On November 25, 2013, the UK Financial Conduct Authority (the "FCA") published a consultation paper on the changes to the dealing commission rules (the "Consultation Paper"). [1] One of the areas that the Consultation Paper focuses on is the use of dealing commission to purchase "corporate access," that is, the practice where investment managers use the dealing commission to pay a third party (e.g., their brokers) for arranging meetings with the senior management of companies they have invested or are considering investing in. The deadline for responding to the consultation is February 25, 2014.

We will hold a member call to discuss the consultation on Friday, December 20 at 11 a.m. EST. If you plan to participate, please R.S.V.P. to Ruth Tadesse at rtadesse@ici.org so that we ensure that we have enough phone lines.

From within the U.S., dial 1-888-917-8048. From outside the U.S., dial 1-415-228-4857. The passcode is 11265.

A summary of the Consultation Paper is below.

Overview of Proposed Changes

Under the current rules on the use of dealing commission which are set out in Chapter 11.6 of the FCA's Conduct of Business Sourcebook ("COBS 11.6"), [2] an investment manager is prohibited from accepting goods or services from its broker in addition to the execution of its customer orders if it passes on the executing broker's charges (i.e., dealing commission) to its customers and is offered such goods or services in return for those charges.

However, there is an exemption from this general prohibition: this prohibition does not apply if the investment manager has "reasonable grounds" to believe that the goods or services are either "related" to the execution of the relevant trades (commonly referred to as "execution services") or they comprise "research." [3]

There are specified criteria in COBS 11.6 that must be met before any such goods or services can be regarded as "execution services" or "research." Therefore, an investment manager can use dealing commission to purchase corporate access if such corporate access purchased with dealing commission can be assessed to meet the criteria for "execution services" or "research." Given the nature of corporate access, investment managers typically tend to justify corporate access on the ground of it being research. In this regard, the FCA states in the Consultation Paper that "no firm could satisfy us that corporate access could be justified as research" in accordance with the specified criteria. [4] The FCA is of the view that arranging access to corporate management does not amount to research and thus must not be paid for with dealing commission and the fact that the investment manager may develop its own research or conclusion following such access does not make corporate access itself "research" within the meaning of COBS 11.6. [5]

The FCA recognises that a broker may offer additional research in the process of arranging corporate access (such as analytical input before a meeting). However, in such case, "only that limited research element" should be paid for with dealing commission and that element must be given a "reasonable, fair value." [6]

Definition of "Corporate Access Service"

The FCA proposes to define "corporate access service" as "a service of arranging or bringing about contact between an investment manager and an issuer or potential issuer." [7] The Financial Service Authority (the predecessor of the FCA) published a thematic review on conflicts of interest between asset managers and their customers in November 2012 (the "Thematic Review") which also discussed "corporate access." [8] The proposed definition of "corporate access service" can be contrasted with the concept discussed in the Thematic Review which defined "corporate access" as the practice of third parties arranging for asset managers to meet with corporate management which "does not refer to any research services that might be provided by the third party alongside providing access to company management." [9]

Pursuant to the concept used in the Thematic Review, it seemed debatable whether "corporate access" bundled together with (i.e., provided alongside) other research services should fall within the exemption and thus could be paid for with dealing commission. By contrast, the proposed definition in the Consultation Paper is much "cleaner" and removes any room for such argument.

Exemption Under COBS 11.6.3R

Under the current exemption in COBS11.6.3R, an investment manager can pay from dealing commission for goods or services if it has "reasonable grounds" to believe that the goods or services are either "execution services" or "research."

By contrast, the proposed rule is simply that the exemption applies if the relevant goods or services are "directly related" to execution or they amount to "substantive research." [10] In other words, an investment manager will no longer be able to make a judgement, the element of "reasonable grounds" having been removed. This means that the new test will focus on whether the specified criteria are met objectively, whereas the current

“reasonable ground” test (notwithstanding the criteria) arguably provides certain discretion to investment managers.

Further, the proposed guidance expressly provides that the FCA does not regard “corporate access service” as meeting the exemption criteria, that is, it will not be considered to be research or execution service. [11] This essentially means that, if the proposals are adopted, investment managers will no longer be able to pay for corporate access out of dealing commission and will have to charge the cost (if any) of corporate access separately to their customers.

Disaggregation

Corporate access services are often provided by brokers as part of a bundled service package together with other value added services. In this regard, where a good or service received by an investment manager includes both elements of “substantive research” and elements that are not “substantive research,” the FCA proposes that the exemption applies only to those elements that are “substantive research;” and the investment manager should disaggregate such good or service so that dealing commission is used to pay for the “substantive research” elements only. [12]

If this requirement is implemented as currently proposed, where its broker arranges corporate access as part of a bundled package which also includes other value added services, an investment manager may need to adjust its brokerage arrangements so that it can readily disaggregate corporate access services from substantive research services. Further, invoicing practices of brokers may also need to be changed so that, for example, where a corporate access service cannot be fully unbundled, a “fair reasonable” value can be attributed to it.

Conclusion

Given the “clean” definition of corporate access service and the express guidance that corporate access will not be regarded as research or execution service, if the proposals are implemented as they are currently drafted investment managers may need to make changes to their operational arrangements. Following the publication of the Thematic Review, some of the required changes may have already been made or are being considered by the industry.

The FCA states in the Consultation Paper that even with the proposed changes there are “inherent flaws” in the use of dealing commission to fund research. The FCA is prepared to scrutinise this area further in the wider context of making the investment management industry more transparent and cost efficient in its consumption of execution related services and research. [13]

It should be noted, however, that the FCA emphasises that it is not banning corporate access or investment managers paying for it (provided it is done in compliance with the regulatory requirements); and it is also not mandating how the cost of corporate access should be allocated. [14] The purpose of the proposed changes is to ensure transparency and mitigate the risk of potential conflicts of interest (e.g., where an investment manager directs business to brokers who arrange corporate access rather than on the basis of the best execution terms).

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endnotes

[1] The FCA consultation paper (CP13/17) is available at: http://www.fca.org.uk/static/documents/consultation-papers/cp13-17.pdf.

[2] COBS 11.6 is available at: http://fshandbook.info/FS/html/handbook/COBS/11/6.

[3] COBS 11.6.3(2)R.

[4] Paragraph 2.25 of CP13/17.

[5] Paragraphs 2.26 and 2.27 of CP13/17.

[6] Paragraph 2.28 of CP13/17.

[7] The draft amendments to the Glossary in Appendix 1 to CP13/17.

[8] "Conflicts of interest between asset manager and their customers: identifying and mitigating the risks"; available at: http://www.fca.org.uk/static/pubs/other/conflicts-of-interest.pdf.

[9] Footnote 1 on page 8 of the Thematic Review.

[10] Draft COBS 11.6.3(2)R in Appendix 1 to CP13/17.

[11] Draft COBS 11.6.8(4A)G in Appendix 1 to CP 13/17.

[12] Draft COBS 11.6.8A(2)G in Appendix 1 to CP13/17.

[13] Paragraphs 3.2 and 3.3 of CP 13/17.

[14] Paragraphs 1.20 and 1.21 of CP 13/17.
