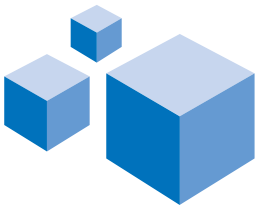

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FCA Rules on the use of dealing commission

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Introduction

Following its consultation on the use of dealing commission rules for investment managers in 2013 (CP13/7), the FCA published its final rules in its policy statement in May 2014 (PS14/7). PS14/7 sets out the changes to be made to COBS 11.6 (Use of dealing commission) of the FCA Handbook and these came into effect on 2 June 2014.

The rules in COBS 11.6 aim to ensure that investment managers only receive eligible goods and services in return for commissions and that the investment manager considers their duty to act in the best interest of their clients when deciding whether to pass on charges to those clients.

The use of dealing commission rules in COBS 11.6 apply to the investment management activities of AIFMs, UCITs and MiFID investment managers.

Dealing commission regime

The dealing commission rules are designed to limit the ability of investment managers to pass certain management costs through to their customers via commission payments and currently prevent investment managers from acquiring any goods and services from brokers in return for client dealing commissions, except for execution-related and research goods and services, which are exempt from the ban. The rules are based on the investment manager's duty to act in the best interests of their customers and are designed to ensure that firms make efficient decisions, in the interests of their clients, about trade execution and the purchase of ancillary services, such as research, and are accountable and transparent in the costs charged to their customers.

The changes introduced in June 2014 support the FCA's operational objectives of enhancing consumer protection and market integrity by ensuring dealing commissions are only used to acquire eligible goods and services, and that these costs are subject to proper controls by investment managers in line with the original policy intention. The changes do not impose new requirements on firms, but provide guidance and clearer drafting to enable firms to ensure that they are acting in compliance, and ensure that the use of commissions is interpreted correctly as only a narrow exemption, allowing the investment manager to pass on only a limited range of costs – those directly related to execution of trades or the provision of substantive research – to their customers.

The rules in COBS 11.6 can be summarised as follows:

1. COBS 11.6.3R states that an investment manager must not accept any goods or services which it charges to its clients, save where the investment manager has reasonable grounds to be satisfied that the relevant goods or services:

   (a) will reasonably assist the investment manager in the provision of its services to its clients on whose behalf the relevant orders are being executed;

   (b) will not impair, or are not likely to impair, the investment manager's duty to act in the best interests of its client; and

   (c) are either: (i) directly related to the execution of client trades; or (ii) amount to the provision of substantive research.

2. COBS 11.6.5E clarifies the meaning of substantive research, namely that the relevant research must:

   (a) be capable of adding value to the investment or trading decisions by providing new insights that inform the investment manager when making such decisions about its customers' portfolios;

(b) whatever form its output takes, represent original thought, in the critical and careful consideration and assessment of new and existing facts, and must not merely repeat or repackage what has been presented before;

(c) have intellectual rigour and must not merely state what is commonplace or self-evident; and

(d) present the investment manager with meaningful conclusions based on analysis or manipulation of data.

COBS 11.6.5E introduces a presumption that charging goods and services to dealing commission that do not meet the above cumulative criteria will tend to establish non-compliance with, and a breach of, the dealing commission rules.

By using 'substantive' research in the new COBS 11.6, the FCA states that it is intending to emphasise the existing, cumulative nature of the criteria and that a good or service should have self-evident, stand-alone content that can help inform an investment manager's decisions.

3. COBS 11.6.6G provides that post-trade analytics as an example of goods or services which do not meet the evidential criteria relating to the execution of trades.

   In addition, COBS 11.6.7G sets out that historical price feeds and data are specifically not substantive research that can be paid for with dealing commissions.

   COBS 11.6.8G provides a further, non-exhaustive list of goods and services which the FCA regards as being outside the scope of use of the dealing commission regime and which now includes corporate access services at (4A). A 'corporate access service' is defined as a service of arranging or bringing about contact between an investment manager and an issuer or potential issuer.

4. COBS 11.6.8AG is a new guidance provision which clarifies:

   (a) how investment managers might approach judgements around their duty to act in the customer's best interests when intending to pass charges on to the client through dealing commission for goods and services; and

   (b) the FCA's expectations around making mixed-use assessments where 'substantive' research is provided alongside another good or service that is not permitted to be paid for through the use of dealing commission.

Since the revision of COBS 11.6, the FCA has considered the dealing commission regime in the context of its broader focus on wholesale conduct, which led to the publication of its discussion paper in July last year (DP14/3). DP14/3 looked at the way firms use dealing commission and also sought views on the potential for reform to the regime in light of MiFID II and ESMA's draft advice to the European Commission on delegated acts supporting MiFID II.

The FCA published its feedback statement on DP14/3 in February 2015 (FS15/1) in which it concluded that it preferred to consider any wider reforms to the use of dealing commission through the discussion in MiFID II to ensure a consistent EU-wide approach.

MiFID II and reform of the dealing commission regime

ESMA's final advice to the European Commission was published in December 2014. In FS15/1, the FCA stated that it strongly supported ESMA's final proposals on inducement and research as a basis for the final delegated acts to support MiFID II.

ESMA's proposals require investment managers to separate the purchase of research from execution arrangements and costs. Investment managers would still be able to purchase research provided it is paid for either:

(a) directly from their own resources; or

(b) through a 'research payment account' funded by a specific separate charge to their client, which is agreed and disclosed upfront. The change must be based on a research budget set by the firm and cannot be linked to execution volumes or value (i.e. dealing commissions or spreads). Further, clients will also receive periodic disclosures on the total amount actually charged for research and how revenues have been used from the research payment account, with the option to request a more detailed summary of payments made to research providers and the goods and services received.

The FCA has welcomed ESMA's proposals, as it considers that separating the purchase of research from execution arrangements and costs removes the inherent conflicts of interest for investment managers that are created by embedding the receipt of research within execution arrangements. Such conflicts of interest can lead to poor controls over costs passed to customers and may unduly influence execution decisions. The FCA considers that the proposed rules will lead to direct accountability over the expenditure on third party research by investment managers and how these costs are passed on to their clients, leading to better outcomes for investors across the EU.

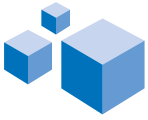
Next Steps

The FCA confirms in FS15/1 that investment managers must continue to comply with the existing rules in COBS 11.6. However, they should start considering how they may need to change their controls now and should not wait until 2017 if changes are needed.

The FCA makes it clear in FS15/1 that it does not envisage consulting on detailed policy proposals, or making any changes, in respect of the domestic dealing commission rules, given the interaction with potential EU reforms. It states that its preference remains to implement any further changes to domestic inducements and use of dealing commission rules in line with the final reforms under MiFID II. The FCA intends to publish a consultation on its overall implementation of MiFID II, which will include the use of dealing commission, by the end of this year.

If you would like to discuss this further, please contact Claire Cummings at claire.cummings@cummingslaw.com or on 020 7585 1406.

This document is for general guidance only. It does not constitute advice
November 2015



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