Financial Conduct Authority

FCA
FINANCIAL CONDUCT AUTHORITY

Feedback statement on DP14/3 – Discussion on the use of dealing commission regime

February 2015

Feedback Statement

FS15/1

Contents

Abbreviations used in this paper 3

1 Summary of feedback, ESMA's final advice on MiFID II and our response 5

2 Next steps 17

Annex

1 List of non-confidential respondents 19

In this Feedback Statement we report on the main issues arising from Discussion Paper 14/3 *Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research*.

Please send any comments or queries to:

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We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

You can download this Consultation Paper from our website: www.fca.org.uk.

Abbreviations used in this paper

AIFMD	Alternative Investment Fund Managers Directive
AIFMs	Alternative Investment Fund Managers
COBS	Conduct of Business Sourcebook
CSAs	Commission Sharing Arrangements
DP	Discussion Paper
EC	European Commission
ESMA	European Securities and Markets Authority
EU	European Union
FCA	Financial Conduct Authority
FS	Feedback Statement
IOSCO	International Organisation of Securities Commissions
MiFID	Markets in Financial Instruments Directive – consisting of Directive 2004/39/EC ('MiFID Level 1') and the Implementing Directive 2006/73/EC ('MiFID Level 2')
MiFID II	The recast Markets in Financial Instruments Directive 2014/65/EU ('MiFID II Level 1') – there will also be a recast Directive 2006/73/EC ('MiFID II Level 2')
SMEs	Small and medium-sized enterprises
UCITS	Undertakings for Collective Investment in Transferable Securities

1. Summary of feedback, ESMA's final advice on MiFID II and our response

Introduction

1.1 This paper is a response to Discussion Paper 14/3 (DP14/3), which we published in July 2014. It is part of our work looking at the way firms use dealing commission – the charges paid by consumers when investment managers execute trades and acquire external research on their behalf. These charges are worth around £3 billion a year. This review forms part of our broader focus on wholesale conduct, to ensure practices and controls by firms engaged in wholesale activities do not lead to poor outcomes for end investors.

1.2 In the DP, we presented our findings from thematic supervisory work and policy analysis of our existing dealing commission regime based on roundtable discussions with market participants carried out in the first half of 2014.

1.3 DP14/3 also included and sought views on our competition analysis of two potential options for reform following the European Securities and Markets Authority's (ESMA) draft advice to the European Commission (EC) on the delegated acts to support the revised Markets in Financial Instruments Directive (MiFID II), published in May 2014.[1]

1.4 ESMA's final advice to the EC was subsequently published in December 2014.[2] We strongly support ESMA's final proposals on research and inducements (section 2.15). We consider that EU reform proposals to separate portfolio managers' payments for research from execution arrangements will better align their incentives to control costs and procure research in the best interests of their customers, and will improve competition in the market for research. However, the EC will draft the actual legislative proposals during 2015, taking into consideration ESMA's final advice as well as the views of the European Parliament and European Council, which also have 3 months to formally scrutinise and object to the EC's adopted legislation (with an option to extend this period by a further 3 months) before it is finalised.

1.5 This feedback statement (FS) provides:

i. a summary of ESMA's final advice to the EC on proposals for the delegated acts under MiFID II and our views on it, including our interpretation of the likely implications of the changes if implemented by the EC

ii. feedback on the responses to the questions in DP14/3 that sought views on our analysis of two options for change based on ESMA's draft advice proposals

1 ESMA, *Consultation paper: MiFID II / MiFIR* (May 2014), Section 2.15. Source: www.esma.europa.eu/content/Consultation-Paper-MiFID-IIMiFIR

2 ESMA, *Final report: ESMA's Technical Advice to the Commission on MiFID II and MiFIR* (19 December 2014), Section 2.15. Source: www.esma.europa.eu/content/Technical-Advice-Commission-MiFID-II-and-MiFIR

1.6 In Chapter 2, we set out the next steps in the EU process for MiFID II and how we intend to implement the final legislation in the UK. Our preference is to make any further changes to our current use of dealing commission rules through or alongside implementation of MiFID II reforms. However, we will need to review our approach once the final details of the legislation are confirmed and consider the interactions with our existing requirements. For example, we may need to consider the treatment of AIFM and UCITS investment management activities. We may also seek to provide further detail on our expectations in a UK context if this is desirable and if consistent with EU law.

1.7 We also note what we expect from investment management firms in the intervening period between now and when MiFID II applies from 3 January 2017.

Who does this affect?

1.8 This FS will interest:

- Investment managers, including UCITS management companies when carrying on scheme management activity and alternative investment fund managers (AIFMs) carrying out AIFM investment management functions respectively.
- Customers of investment managers, including:
  - institutional investors, for example retail fund and pension fund trustees
  - retail investors who have investments in retail funds (which may be through a wrapper such as an Individual Savings Account), or who have a direct relationship with an investment manager, for example individuals with discretionary-managed investment portfolios.
- Brokers (including investment banks), and third-party providers of independent research and other ancillary services supplied to investment managers.
- Corporate issuers.
- Relevant trade associations and representative bodies for the above groups.

Context

1.9 In DP14/3, we reported on our:

- findings from our thematic supervisory work, in which we reviewed 17 investment managers and 13 brokers to examine current practices under our dealing commission regime
- policy analysis following roundtable discussions with over 130 market participants and associations
- views on ESMA's Consultation Paper on draft proposals for its advice to the EC on the delegated acts to support requirements in MiFID II level 1

1.10 ESMA's draft proposals in May 2014 suggested that, based on the inducements restrictions in MiFID II, portfolio managers should be prevented from receiving more valuable research linked to their execution arrangements with brokers and transaction costs passed to customers. Portfolio managers would still have been able to purchase research directly from their own resources, and receive generic, low value research as a minor non-monetary benefit.

1.11 While supporting ESMA's advice based on our review findings, we suggested that there may be further benefits if portfolio managers were prevented from receiving any research under execution arrangements. We concluded that the benefits outweighed potential negative impacts. These benefits included:

- improved transparency and accountability of investment managers' spending on behalf of their customers, removing the inherent conflicts of interest in the current mechanism of using dealing commissions to acquire research
- more direct incentives for investment managers to rigorously assess value for money when purchasing third-party research on behalf of their clients. This would be likely to drive a corresponding improvement in the quality and cost of research, and
- a priced research market that would lead to more effective competition between brokers and independent research providers, resulting in more innovation and specialisation in their goods and services

1.12 We asked for views on this analysis. We also noted our preference for pursuing any further reform through or alongside MiFID II to ensure a harmonised EU regime.

ESMA's final advice on research and inducements proposals for the MiFID II delegated acts

1.13 We indicated that our feedback to DP14/3 would follow the finalisation of ESMA's advice to the EC on the MiFID II delegated acts, which was published on 19 December 2014.

1.14 We welcome ESMA's final advice on inducements and research, and would support it as the basis for the final delegated acts to support MiFID II Level 1.

1.15 ESMA's approach requires portfolio managers to separate the purchase of research from execution arrangements and costs. It removes the inherent conflicts of interest for portfolio managers that are created by embedding the receipt of research within execution arrangements with individual brokers, which can lead to poor controls over costs passed to customers and may unduly influence their execution decisions.

1.16 ESMA's advice on inducements and research confirms that the current market mechanism under which portfolio managers receive third-party research in return for and linked to variable costs of execution that are passed directly to the portfolio manager's clients is a form of inducement under MiFID. So ESMA maintains the approach that the Level 1 restriction on inducements for portfolio managers and independent advisors does apply to these arrangements.

1.17 However, ESMA's final advice also outlines a positive model for how research can still be paid for by portfolio managers, such that it does not constitute an inducement. This departs from their draft advice, which sought to classify certain types of research as a 'minor non-monetary benefit' while excluding more valuable research from being acquired under execution arrangements.[3]

1.18 Under ESMA's final proposals, an investment manager can purchase research provided it is paid for either:

a. directly by the firm out of its 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 charge 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)

1.19 To further enhance transparency under option (b), 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.

1.20 Investment firms (e.g. brokers) providing both execution and research services to a portfolio manager should identify a separate fee for the execution service, with any additional goods and services subject to a separate charge that is not influenced by levels of payment received for execution. ESMA also suggests further guidelines to support these proposals may be useful.

1.21 ESMA also indicates that the EC may wish to consider extending the final MiFID II requirements to investment management activities carried out under the AIFM and UCITS Directives, to ensure a harmonised approach across these areas.

1.22 ESMA summarises the approach by stating:
The proposal makes clear that there should be no payment for third party research linked to the payments made for execution of orders. This will address the potential inducements and conflict of interest issues that currently exist for portfolio managers when they receive third party research linked to execution arrangements with the broker. The proposed approach will also create more transparency over spending on research to improve outcomes for consumers.[4]

1.23 ESMA also notes that, by placing a requirement on brokers to price and supply research separately from their execution services provided to portfolio managers, it will: 'ensure transparency in the market, allowing investment firms to better demonstrate their compliance with the inducements requirements and wider conflicts of interest provisions, and allow competent authorities to more easily detect any poor practices.'[5]

Our response

1.24 We believe ESMA's proposal will lead to direct accountability over the expenditure on third-party research by portfolio managers and how these costs are passed to their customers, leading to better outcomes for investors across the EU.

3 See ESMA, Consultation paper: MiFID II / MiFIR (May 2014), page 121, paragraph 14.
Source: http://www.esma.europa.eu/content/Consultation-Paper-MiFID-IIMiFIR

4 *ESMA's Technical Advice to the Commission on MiFID II and MiFIR*, p.133

5 *ESMA's Technical Advice to the Commission on MiFID II and MiFIR*, p.134

1.25 By clearly separating the payment for research from execution arrangements, it removes the inducement risk and conflicts of interest for portfolio managers that their execution behaviour and choice of brokers may be unduly influenced. This will drive proper scrutiny by portfolio managers over the amounts paid for research and the benefits it provides and also improve their ability to monitor and comply with best execution obligations on behalf of their customers.

1.26 Importantly, it recognises that external research can be a core cost of business to a portfolio manager in developing investment ideas. It will, under ESMA's proposals, be a cost and charge that is akin to a portfolio manager's own spending on analysts and internal research, which they already reflect in their upfront annual management charges (AMCs). Research would no longer be paid for in transaction fees that have no correlation to the quantity and value of research received and consumed.

1.27 ESMA's approach will also promote transparency and competition in the market for research, allowing independent providers to compete more easily with larger brokers based on price and quality – encouraging a focus on value-added coverage.

1.28 The 'research payment account' option created by ESMA also takes into account some of the concerns expressed by stakeholders in the consultation (and in responses to our DP) on the impact on smaller asset managers and the availability of small and medium-sized enterprise (SME) research in the market.

1.29 The flexibility over how research costs are absorbed by portfolio managers should also reduce concerns over the short-term transition to this new model. It will allow portfolio managers to budget and pay for research that adds value to their clients, while adding scrutiny such that it is unlikely managers will continue to pay for low value, duplicative research, reducing overproduction and inefficiency in resource allocation by providers.

1.30 Overall, we believe it will address long-standing concerns from our supervisory work that current market practice – even with our specific dealing commission rules and disclosure requirements – is not delivering a good outcome for investors. The combination of improved cost control and scrutiny over research purchasing and execution decisions by investment managers, with more effective competition in the market for research, should lead to improved outcomes for investors.

Our views on technical aspects of ESMA's advice

Interaction with Commission Sharing Arrangements and existing market practices
While borrowing some features from CSAs, ESMA clearly expresses the view that CSAs 'do not entirely address the conflicts of interest at stake' and indicates that they have 'formulated additional requirements which are aimed at further limiting these conflicts of interest.' In the technical advice, ESMA proposes that the research payment account and charge should be agreed upfront between the portfolio manager and their client, and be based on a budget set by the firm relating to their external research needs and not linked to trading volume or values. It also requires the portfolio manager to be responsible for operating the research payment account and managing the allocations made from within their budget.

Moreover, current CSA approaches would seem incompatible with the intention of ESMA's proposals, and specifically the view that there should be no link between execution and research payments. The fundamental principle underpinning ESMA's advice is that research

provided under 'bundled' execution arrangements is an inducement and can create potential conflicts of interest for the portfolio manager, and MiFID II Level 1 now restricts the receipt of inducements relating to portfolio management. Taken together, this indicates that the research payment account is a new, distinct payment vehicle. Indeed, it appears inconsistent with the best interests of a portfolio manager's customers to continue using CSAs, which still rely on execution commissions to fund research, and do not reflect the focus in ESMA's proposals on portfolio managers agreeing research charges upfront with customers based on a predicted, budgeted assessment of their research needs.

In our view, the intention of the technical advice is to create a 'hard dollar' research market, with the option for research invoices to then be paid either by the investment firm itself, or a from a research payment account linked to the client portfolio that has benefitted from the research received. We also believe ESMA's proposals allow for the costs of research to be allocated across several research payment accounts on a pro rata basis, where more than one client portfolio benefits from the common consumption of that research by the manager. We envisage that firms could have standard written policies in place to govern their use of research payment accounts and gain agreement from clients to both upfront charges and their approach to allocating costs, so this process is not too burdensome on firms, while being transparent to clients.

The scope of ESMA's advice: application to fixed income

ESMA's advice is not limited by types of MiFID financial instruments and so the restriction on inducements would relate to any third-party research received in the course of providing portfolio management or independent investment advice under MiFID. The advice and options for how research can be provided in such a way that it is not an inducement would therefore equally apply to fixed income research. In fixed income, costs of research, as well as some other discrete costs, are usually embedded within the negotiable bid / offer spreads quoted by brokers. We believe this would mean that, in the new regime, a manager would have the option either to pay directly for research, or use the research charge and payment account to do so, which can be applied to clients with fixed income portfolios in the same way as for equities. If research is currently a material part of a broker's costs, we would expect a narrowing of spreads as a result of the decoupling of research from trading spreads.

Evidence suggests there is much less research on the credit markets produced and consumed for fixed income than for equities, and levels of payments for it are likely to be much smaller for this reason (in which case, any adjustment in spreads may be less pronounced). However, applying ESMA's approach to fixed income markets will bring transparency in an area that is currently more opaque than equity markets since research is entirely embedded in implicit transaction costs. It will open up the market for providing research on the credit markets to firms other than brokers in the bond markets. An independent research provider wishing to supply research on the credit markets currently faces a significant competitive disadvantage compared with brokers, as there is no mechanism such as CSAs to allow a third-party research provider to be paid from transaction costs and no market precedent for 'hard dollar' payments in this area.

Summary of feedback to DP14/3

1.31 We received 46 responses to DP14/3. Respondents included investment managers, research and ancillary service providers, brokers, investor-representative bodies, individuals, and trade associations. Non-confidential respondents are listed in annex 1.

1.32 Most of the feedback referred to earlier submissions to ESMA's Consultation on its draft advice, which ran from 22 May to 1 August 2014. Comments received reflected a variety of opinions on our analysis, both on ESMA's proposals and our option to require portfolio managers to receive and pay for all research separately from execution costs.

1.33 Responses were grouped into the following three broad sets of opinions:

- Investor-representative groups, some ancillary service providers, and private individuals who strongly supported reforms to unbundle research provision and payments from execution services and transaction costs, agreeing with our analysis of issues in the current regime, and the likely benefits from reforms.

- A number of trade associations and individual buy-side and sell-side firms who acknowledged further improvements were needed to the current regime to produce better outcomes for investors, but felt that these could be achieved by building on our existing use of dealing commission rules. Proposals focused on mandatory use of commission sharing arrangements, research budgets and better internal governance by investment managers, allied with more disclosure to investors.

- Other trade associations and firms disagreed with our analysis that the existing regime had inherent flaws, and / or felt that more radical reform would potentially have unintended negative consequences that would be greater than the benefits. Common concerns cited included: whether smaller investment managers would be able to absorb the costs of third-party research if they had to bear this themselves; the possibility of reduced research coverage in the market if managers are less willing or able to pay for it; and the possible divergence in approaches between the EU and other international jurisdictions if regulatory changes occur.

1.34 There was no new substantive evidence submitted, although some respondents noted existing studies (e.g. on the nature and scale of transaction costs) or provided results of recent opinion surveys of selected market participants on their views of possible reform options. While we considered these responses carefully, they did not add significantly new evidence or arguments compared to our analysis in DP14/3.

Key points in submissions and our response

Views supporting reform to decouple research from execution arrangements

1.35 Individual responses, representative groups for underlying investors, and some third-party service providers agreed with our analysis in DP14/3 and support for more radical reform. These respondents also favoured the second option set out in our DP, to prevent all research being provided linked to execution arrangements. Many felt that ESMA's draft advice, which proposed an exemption for 'generic' research, could be exploited to allow investment managers to continue to receive a wide range of goods and services from brokers, and so fail to address the inducement risk.

1.36 Several respondents included links to existing analysis that showed the significant level of total transaction costs borne by portfolio managers' customers. These submissions argued that the lack of transparency and incentives to control dealing commissions were a factor in these high transaction costs.

1.37 Several respondents expressed the view that there is currently an over-supply of low value, duplicative research coverage of large corporates. One respondent felt there was a decade-long trend of fundamental research on companies being reduced as brokers focused more on selling and marketing less in-depth, results-driven coverage and providing direct access to their analysts or issuers' company management. Most felt that dealing commission arrangements incentivised this trend, as by linking the receipt of research to execution fees it encourages higher volumes of trading while reducing the focus on the value of discrete research goods and services. Another respondent also noted that since 35-40% of stocks currently have no research coverage, dealing commissions have not helped to sustain breadth or depth of SME research as some have claimed.

1.38 These respondents all argued that reform to require a full separation of research acquisition from execution arrangements would reduce the payments that investment managers currently direct towards duplicative research through dealing commissions. Instead, investment managers would purchase more value-added, in-depth research on smaller companies and niche sectors to better inform investment ideas for their clients.

1.39 However, some felt that even if research costs are removed from execution costs, there may be a risk that brokers would seek to retain higher execution rates or spreads while providing 'free' research to portfolio managers. They proposed that the FCA would need to carefully supervise any new regime to ensure compliance. There was also a proposal to require all costs, including execution-only transaction costs, to be included within the AMC paid upfront by the client, which would mean that all ongoing costs would be borne by the investment manager.

Our response

We believe ESMA's final proposals will achieve similar benefits to the second reform option discussed in the DP, and as noted above in paragraphs 1.24-1.30. ESMA's reform proposal is based on the principle of requiring a full separation of portfolio managers' payments for third-party research (and how they account for these costs to their customers) from the execution of orders with brokers. ESMA's final proposals will remove the inducement and conflicts of interest that can otherwise arise for portfolio managers in their arrangements with brokers.

We would expect execution rates or spreads to reduce to reflect the removal of any costs of research currently priced into these rates by brokers. We believe that the separation of costs will improve the ability to monitor best execution, and given the existing competition between brokers and venues for execution-only business, we think it is unlikely that firms could maintain higher transaction fees to subsidise other services.

Views supporting more incremental reform using budgets and CSAs

1.40 A number of respondents agreed with our analysis that weaknesses remain in our dealing commission regime, but felt that a majority of the issues could be addressed by mandating current features of market practices and more limited additions to our rules, while still allowing the use of dealing commissions to fund research. These responses generally proposed a similar set of combined reforms, which were:

- Mandating use of CSAs by all investment managers, requiring any commission on a trade used to fund research having to be split for execution and research, with the latter allocated into a CSA;

- Requiring external research budgets to be set by the investment manager, based on proper valuations and assessment of their research needs, and not based on any link to trading volumes. They would then use CSAs to ensure they only generated dealing commissions up to that budget and then switching to execution only rates. Some suggested the overall budget could be cascaded and used to set further caps on spending within the firm e.g. by desk or for particular research providers;

- Internal governance improvements by investment managers, to include oversight of budgets and valuation processes, and a full separation of mechanisms to determine allocations of commission for research from trading functions and decision-makers (more robust 'broker voting' or 'research voting' to reflect their actual purpose, with some suggesting 'investment committees' to value research and ensure consistent allocation across a firm).

- Improved disclosures to clients, for example by including research costs within ongoing charges figures (OCFs) or providing more detail in disclosing which providers were paid and presenting costs in cash terms. Some suggested stating third-party research costs as a % of assets under management, while another view was that an upfront cost could be estimated based on a budget, and pro-rated and disclosed to individual clients.

1.41 Respondents advocating this more evolutionary reform approach pointed to the fact that our supervisory review had identified two firms who had met our expectations within the framework of the current rules. They felt the combined features above – if implemented by all firms – would sufficiently improve control of costs by limiting the effect of execution volumes on research spending and encouraging more robust efforts to value research. Better disclosure to customers would also enhance scrutiny of these costs and would discipline investment managers' behaviours.

1.42 They also noted the reduced disruptions if existing market mechanisms were used, compared to removing the ability to fund research with dealing commissions completely, which some felt could have various negative unintended consequences (discussed further below).

Our response

Our DP did recognise that the use of CSAs supported by rigorous budgets and internal controls over use of dealing commissions by an investment manager represented sound practices under our current regime, and helped to manage some of the conflicts of interest created by the use of a transaction cost to fund research. However, as we also set out in the DP, CSAs and budgets do not resolve all of the potential conflicts of interest nor the inducements issue for portfolio managers, and still present barriers to transparency and competition in the research market by linking research to transaction costs. ESMA's final advice reached a similar conclusion, as discussed above.

However, we believe that some market practices and tools developed in the context of CSAs – such as software platforms to manage these accounts and investment managers who already set third-party research budgets based on robust valuation processes – could be transferrable to managing the new research payment accounts ESMA proposes.

Views supporting the current regime and noting concerns about potential negative consequences of more significant reforms

1.43 There were respondents who disagreed that the existing regime needed further reform. They viewed investment managers would only buy research and incur costs if it was in their client's best interests, and that there was no real conflict of interest in current dealing commission arrangements. Several noted the large number of investment management firms and low concentration in the sector, and argued this showed that there was effective competition. Some respondents felt that existing cost disclosures to customers were sufficient to allow them to challenge their manager, but few did so.

1.44 Some pointed to long-term trends in gross execution commission charges, which had reduced, and so argued that costs were being controlled effectively. These submissions also argued for the benefits of the current system, such as relative consistency in international regulators' current approaches to the bundling of goods and services with execution arrangements; positive cross-subsidies / enhanced access to research for smaller investment managers created by the use of commissions; and the beneficial VAT tax treatment stemming from an ability to bundle services.

1.45 Most of the comments in favour of the current regime also strongly disagreed that there would be an overall benefit from any reform that required portfolio managers to purchase research separately from execution arrangements. Potential negative unintended consequences of such reform that were commonly mentioned were:

- A concern that if investment managers had to bear the cost of external research directly, they would not be willing (or able, in the case of smaller managers) to absorb the cost themselves, nor pass it on in higher annual management charges. They would instead cut their spending on third-party research entirely, possibly leading to poorer investment decisions being made and a loss of performance to clients that may offset any cost-saving. Having to bear the cost of third-party research directly and upfront was also viewed as a barrier to smaller portfolio managers and start-ups, while large firms could absorb costs more easily. It was argued that this could lead to consolidation and less competition in the sector.

- Linked to the above assumption that managers would drastically cut spending on third party research, some respondents felt research coverage may reduce as a result of smaller brokers and independent research providers' business models becoming unsustainable. This, it was argued, could have a greater impact on SME research coverage in particular. As a consequence, SMEs may face reduced access to capital and more illiquidity and price volatility in their shares. A few bodies representing listed companies also raised concerns that the cost-benefit and competition analysis in our DP had not considered the costs that could fall on smaller companies if they had to pay for their own research coverage.

- Some respondents voiced concerns that EU investment managers may appear less competitive compared to overseas competitors if they were required to separate research payments from execution arrangements and reflect research costs upfront. There were also fears that reforms for EU portfolio managers may mean they are unable to obtain services from overseas brokers, particularly from US firms.

Our response

Our policy debate and analysis reported in the DP carefully considered a range of views alongside our own supervisory evidence. Responses to the DP have not raised new arguments or evidence to lead us to alter our conclusion that the current regime requires further reform to ensure it delivers good outcomes for consumers.

As we set out in our analysis in the DP (see paragraph 5.38 of DP14/3), we believe a reform that fully separates portfolio managers' receipt of research from execution arrangements will improve competition in the research market. It will provide greater incentives on the manager to secure value for money when purchasing research, resulting in an improvement in the quality, and reduction in cost of, research provided by the market. We believe portfolio managers will still wish to buy value-added research to provide a flow of investment ideas, including research on SMEs (which can have higher growth potential). Customers would accept upfront charges for research, based on the perceived benefit to their portfolio and the actual reductions in transaction costs.

We also expect such reform would increase the potential number of suppliers of research, and drive more innovation and specialisation. Our evidence indicates that dealing commission arrangements currently favour the largest brokers and not the independent research providers or small brokers who supply more research on SMEs. We also concluded that, following some initial transitional costs, smaller managers would not have higher ongoing costs or find it more difficult to pass costs to clients if they had to pay for research directly, nor would they be in a worse position relative to larger managers.

While our views remain unchanged, ESMA's final advice addresses the concerns expressed about smaller portfolio managers' ability to absorb costs of external research if they are prevented from funding this via dealing commission arrangements. The flexibility for the portfolio manager to continue to pass research costs to clients – subject to upfront agreement of these charges and clear accountability over their spending – will ensure managers can continue to obtain value-added research for their customers.

ESMA's approach also mitigates purported concerns that if investment managers reduced research budgets to below an optimal level, it may damage the ability of independent research providers to operate and reduce demand for coverage of SMEs.

We acknowledge that many portfolio management firms operate on a global basis. However, we believe that enhanced accountability by portfolio managers and a more competitive research market has the potential to lower costs and improve returns to customers, which should make EU investment managers more rather than less competitive. MiFID II reforms will also radically enhance disclosures of all costs and charges. We do not support the view that EU portfolio managers may be perceived as less competitive in a global context simply by making research costs a separate, upfront fee. What is included in headline management fees already varies between jurisdictions and investors will look instead to compare total costs.

We are also aware of the concerns that potential MiFID II reforms to require EU portfolio managers to acquire research separately may create barriers in their dealings with non-EEA firms, for example where 'bundled' commission payments are still preferred by firms in other jurisdictions. We believe the scale of the portfolio management sector in the EU should encourage feasible regulatory or commercial solutions in such cases, to ensure overseas firms can still supply EU portfolio managers with services without undermining investor protection. There are already many variations in global regulation that firms have to manage. We are also aware that many globally active investment managers seek to adopt the highest standards internationally to ensure they act in the best interests of their customers. We also continue to discuss these issues with international regulators at IOSCO.

In the DP, we noted our concerns that the current VAT treatment of research can distort competition, favouring brokers (whose fully bundled research tends to be considered as VAT-exempt), over independent research providers (whose services are usually subject to VAT). We expressed our preference for equal tax treatment of research purchased by portfolio managers. However, it will be a matter for HMRC to determine how VAT is applied in the UK based on the final reforms, and any new concepts this may involve, such as ESMA's research payment account and charge.

1.46 Some responses to our DP queried the scope and detailed legal interpretations within ESMA's draft advice for the EC on research and inducements.

Our response

ESMA's final advice discusses views received on their legal interpretations, and responds to confirm their original analysis that research provided under execution arrangements is an inducement. We agree with ESMA's analysis, and we have previously noted that our own use of dealing commission rules are based on the inducements requirements in the current MiFID legislation.

Our concluding response

1.47 While views expressed in response to DP14/3 varied in whether they agreed with our analysis, no substantive or compelling new evidence was submitted. We maintain our preference for reforms to separate the receipt of research by investment managers from execution arrangements, based on the evidence and analysis in the DP. We strongly support ESMA's final advice on inducements and research and would welcome a similar approach in the final delegated acts, which we expect the EC to finalise by the end of this year.

1.48 We believe ESMA's proposals will better align investment managers' incentives to control costs and be transparent with their customers over charges for external research, and remove the inducement and conflicts of interest created by bundling research into execution arrangements with brokers. It will lead to pricing for research by brokers and other providers, encouraging a focus on quality and value for money in this market that will result in more effective competition in the interests of consumers.

2.
Next steps

2.1 This chapter briefly summarises the next steps for:

- investment management firms subject to our existing rules
- the EU process to adopt the final MiFID II requirements, and
- our likely process to implement MiFID II requirements into our Handbook

What do we expect from investment firms?

2.2 Investment managers must continue to comply with the existing rules in COBS 11.6, and ensure they are acting in the best interests of their customers in how they acquire external research and manage the associated costs passed to clients.

2.3 As part of firms' requirements to act as good agents to their customers, they should start considering how they may need to change their controls now and should not wait until 2017 if changes are needed. Those firms who adopt sound practices earlier, such as setting budgets in monetary amounts based on a careful assessment of their research needs and having robust valuation processes for substantive research to ensure that any dealing commission costs incurred are in the best interests of their customers, will be better placed to adapt to the final changes under MiFID II.

2.4 The wider investment management sector might also wish to start considering the need to create new standard documentation and processes to redefine relationships with clients, brokers and research providers if it is considered more appropriate to drive change at industry rather than firm level (subject to preserving competition).

EU process to finalise MiFID II delegated acts

2.5 The EC is now considering ESMA's final technical advice on the delegated acts. It is likely that the EC will put forward draft delegated acts later this year for scrutiny by the European Parliament and European Council. They have three months to review and object to proposals, with an option to extend this period by a further three months, before the EC can adopt the final measures.

2.6 We expect that the final delegated acts will be adopted no later than January 2016. Member states must then adopt and publish measures in domestic law and regulations by 3 July 2016. MiFID II will apply from 3 January 2017.

What will we do?

2.7 Our preference remains to implement any further changes to our domestic inducements and use of dealing commission rules in line with the final reforms under MiFID II. Depending on the form and content of the final legislation, we may also need to consider our approach to areas such as the treatment of UCITS and AIFM investment management activities, and whether it is possible and desirable to consider further detail to clarify our approach to implementing new requirements. We will consult further where appropriate.

2.8 Subject to the EC's progress in finalising the delegated acts, we intend to publish a consultation on our overall implementation of MiFID II, including inducements requirements, by late Q4 2015. We do not envisage any further, separate publications on our dealing commission rules at this stage.

Annex 1
List of non-confidential respondents

Confidential and individual responses: 8

Alliance in Support of Independent Research (USA)

Alternative Investment Management Association Limited (AIMA)

AMAFI-AMG (joint response)

Association for Financial Markets in Europe (AFME)

AXA Investment Managers

Berenberg

BlackRock

British Bankers' Association (BBA)

BVI

CLSA (UK)

European Association of Independent Research Providers (Euro IRP)

Exane Group

Financial Services Consumer Panel

Henderson Global Investors Limited

ICI Global

ICMA Asset Management and Investors Council (AMIC)

Ingage

Investment Adviser Association (USA)

Investment Management Association (IMA) (now the Investment Association)

Investor Relations Society

Japaninvest Group

Kames Capital

Kepler Cheuvreux

M&G Investments

Managed Funds Association (MFA)

Markit

Martin Currie Investment Management

National Association of Pension Funds (NAPF)

New City Initiative

Oldfield Partners

Oriel Securities

Quoted Companies Alliance (QCA)

Redburn (Europe) Limited

Sanford C. Bernstein Limited

Schroders

Standard Life Investments

TT International

USS Investment Management

Financial Conduct Authority

PUB REF: 005016

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