

## Regulator Assessment: Qualifying Regulatory Provisions

**Title of proposal:** Use of dealing commission – multi-firm feedback

**Lead regulator:** FCA

**Date of assessment:** 15 March 2017

**Commencement date:** The findings article was published on 3 March 2017. The relevant applicable rules have been in force since January 2006 with some more stringent rules being clarified in June 2014.

**Origin:** Domestic

**Does this include implementation of a Cutting Red Tape review?** No

**Which areas of the UK will be affected?** All investment management firms that debit a dealing commission charge from its clients.

### Brief outline of proposed new or amended regulatory activity

Our dealing commission rules set strict and clear criteria on what goods and services may be purchased using customer commissions. Previous thematic work (most recently in 2014) concluded that sufficient control and oversight was not being afforded over how firms spend their customers' money and that commission expenditure should be undertaken with as much care and attention as if firms were spending their own money.

Our 2016 review (which the 3 March 2017 publication communicated the findings of) was a follow-up piece of work to assess whether firms had made improvements in relation to how they were spending their customers' commission, whether this expenditure was in compliance with our rules and if customer funds were being expended with as much care and attention as if the money were firms' own resources.

The article was published on the FCA website and set out instances where we believe control and governance structures either made it difficult for firms to adequately monitor and challenge commission expenditure, or alternatively were totally absent. Our statements did not go further than what we had said in previous thematic publications (DP14/3) or policy work (PS14/7).

**Which type of business will be affected? How many are estimated to be affected?**

While this publication is relevant for all investment managers that use customer dealing commission to purchase external research and execution services, our statements did not go

over and above what we have publicly stated in the past. We therefore believe there is a zero cost associated with this. However, there will be a cost related to reading, comprehending and disseminating this information. We estimate that the number of firms this publication is relevant for will be circa 1000 firms.

Price base year	Implementation date	Duration of policy (years)	Business Net Present Value	Net cost to business (EANDCB)	BIT score
2017	2017	10	-0.048	0	0

### **Please set out the impact to business clearly with a breakdown of costs and benefits**

Note – for all cost estimates below we have assumed the changes will be applied by experienced compliance staff at an estimated rate of £48/hour. The 2016 Robert Half salary guide estimates that a compliance manager in the risk and compliance function of a financial services company based in London earns between £70,000 and £104,000 per annum. Based on working 8 hours per day for 260 days each year our rate equates to £100,000 per annum and is therefore considered a suitably prudent figure for the purposes of our estimates.

#### *Familiarisation cost and Gap Analysis cost*

There are approximately 1,600 words in the article. We expect that all of the approximately 1000 investment management firms would find it helpful to familiarise themselves with the article<sup>1</sup>. We would expect that the note would take up to one hour to read, digest, disseminate to relevant members of staff, and, if necessary, update the relevant procedure to reflect the guidance. We would not expect there to be any cost to firms which are already compliant with the underlying rule (although to be prudent we have included all of the estimated 1000 companies in our calculations below)<sup>2</sup>.

The total estimated cost for all 1000 investment management firms would be approximately £48,000. This is an estimate of the maximum amount of time it might take a company to review the article as the note provides illustrative examples of good practices.

#### *Ongoing cost*

We consider that this publication creates no ongoing costs for business because the expectations set out in it are wholly inherent in the existing rules and add no new obligations to those rules for any firms.

A representative sample of the detail of our findings/expectations against previous work on this topic:

Our findings/expectations	Existing rule/guidance
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<sup>1</sup> <https://www.fca.org.uk/news/news-stories/firms-continue-fail-meet-our-expectations-use-dealing-commission>

<sup>2</sup> We arrived at the one hour estimate based on the following calculation. The two page technical note contains approximately 550 words. The speed of reading technical text is 50-100 words per minute based on EFTEC (2013), "Evaluating the cost savings to business revised EA guidance - method paper" the time remaining to digest, disseminate the information and if necessary update the relevant procedures is based on our broader supervisory knowledge of how firms respond to our Technical Notes and also on supervisory conversations with firms about their procedures relating to this specific issue

<p>"At the extreme end, some continued to use dealing commission to purchase non-permissible items, such as corporate access and market data services, contrary to our rules."</p> <p>Corporate access where brokers are paid to facilitate meetings between the investment manager and the corporate. Market data refers to information providers such as Bloomberg and Thompson Reuters. Both of these types of services do not meet our evidential criteria for substantive research and therefore cannot be paid for using customer commissions.</p>	<p>COBS 11.6.8G - Examples of goods or services that relate to the execution of trades or the provision of research that the FCA does not regard as meeting the requirements of either evidential provisions COBS 11.6.4E (1) or COBS 11.6.5E (1) include: (1) services relating to the valuation or performance measurement of portfolios; (3) connectivity services such as electronic networks and dedicated telephone lines; (4A) corporate access services; (8) office administrative computer software, such as word processing or accounting programmes;</p> <p>DP 14-3 1.26: One large firm was using dealing commission to pay for market data services in full with no apparent mixed-use assessment to determine which parts of the services were eligible to be paid for out of dealing commission and which were not. This was despite us setting out our views on the need for firms to assess the eligibility of payments for these services in reports in both 2008 and 2012. Following our engagement, the firm has ceased making payments for these services using dealing commission. The firm is conducting a review of the issue, taking steps to strengthen its controls and is in active discussions with us to determine redress.</p>
<p>"A few firms in our sample now cover the cost of externally produced research from their own resources rather than using dealing commission. These firms take care to ensure that the dealing commission they continue to pay are for execution services only and paid at genuine execution-only rates."</p>	<p>DP 14-3 2.11: We carried out thematic work between 2011 and 2012 on conflicts of interest between asset managers and their customers.<sup>21</sup> In the report on our findings in November 2012, we highlighted our concerns that, despite spending millions of pounds each year through dealing commissions on execution and research, only a few firms we visited exercised the same standards of control over these payments that they exercised over payments made from the firms' own resources.</p> <p>DP 14-3 2.13: We further concluded that: 'Firms with poor controls over how they spend customers' commission put at risk their ability to execute transactions by directing them to counterparties or venues that might not provide best execution.'<sup>22</sup> We also found that firms could not demonstrate compliance with our more detailed rules and evidential criteria on what is eligible research that can be paid for with dealing commission.</p> <p>DP 14-3 3.15: If payment for research and execution is truly separated, firms should</p>

	<p>be able to pay for research without trading with that broker and pay for execution without paying for research. Our work has found that this is often not the case, with investment managers' customers paying for research every time a share is traded, even if there was no research input or investment decisions were based on the investment manager's in-house research.</p> <p>DP 14-3 3.16: We found a number of investment management firms that were trading exclusively or predominately at bundled rates (e.g. without using CSAs). This makes it difficult for firms to pay an appropriate amount for the research they were using, as the research payment is integrally linked to the trading volume.</p>
<p>"Other firms have adopted processes that demonstrate careful consideration and control around how they spend dealing commission. They have driven material reductions in the commission they spend on research through improved management and oversight."</p>	<p>DP 14-3 2.13: We further concluded that: 'Firms with poor controls over how they spend customers' commission put at risk their ability to execute transactions by directing them to counterparties or venues that might not provide best execution.'<sup>22</sup> We also found that firms could not demonstrate compliance with our more detailed rules and evidential criteria on what is eligible research that can be paid for with dealing commission.</p>
<p>"Budgets are frequently linked to historical research spending levels - a factor of past trading volumes rather than an assessment of the amount of substantive research required."</p> <p>"Those firms without any form of budgeting have research spending levels closely correlated to trading volumes. While the efficiency of budgets needs to be improved, 79% of organisations in our sample in 2015 used research budgets compared to just 34% in 2012, so some progress has been made in this area."</p> <p>"Implementing budgets should introduce discipline around how much substantive external research a firm requires and how much of their clients' money they spend on it."</p>	<p>DP 14-3 4.12: There were clear views on some of the better controls applied by some investment managers, and which most felt should be more widely adopted, including:... Setting and managing a total research budget that is not influenced by trading volumes, and applying budget caps for individual brokers or research providers. Research budgets are managed through the careful use of CSAs and management of execution rates, e.g. moving to execution-only rates (from bundled rates) with a broker as soon as the research cap has been reached in a set time period.</p> <p>DP 14-3 1.26: ... In 11 investment management firms, the amount paid for research with dealing commission remained linked to the volume of trades carried out as they did not have research budgets or caps on research spend.</p> <p>DP 14-3 3.20: An example where a firm was rigorously assessing the value of research - One firm had established an internal working group to assess the value of research separately from individual investment managers and set a budget per</p>

	<p>desk. This assessment did not attempt to value every report but instead the overall service provided from each broker to each investment desk. This then translated into a cap for the dealing desk at which point they would switch from CSA to execution only. This firm paid 10-15% less for research in 2013 than they did in 2012 and expects the payments to continue to fall to 60% of the amount paid in 2012.</p> <p>DP 14-3 3.20: An example of a smaller firm assessing value and controlling costs - One of the smaller firms we visited had a strong culture of managing costs on behalf of their clients that came through in the broker vote. Investment managers gave careful consideration to monetary amounts they allocated to each broker based on their assessment of the value of the research used. The firm also provided challenge to their fund managers in the form of a peer-review to consider whether they were consistent in what they assessed as a value-added good or service and that they were focused on using commissions in the customer's best interests. This showed us that a firm's size is not a barrier to managing costs well.</p>
<p>"Greater scrutiny around budgetary requirements, including a comprehensive approach to valuing research, could result in lower costs and/or a more efficient use of dealing commission. This in turn may lead to better returns for investors."</p>	<p>DP 14-3 3.20: An example where a firm was rigorously assessing the value of research - One firm had established an internal working group to assess the value of research separately from individual investment managers and set a budget per desk. This assessment did not attempt to value every report but instead the overall service provided from each broker to each investment desk. This then translated into a cap for the dealing desk at which point they would switch from CSA to execution only. This firm paid 10-15% less for research in 2013 than they did in 2012 and expects the payments to continue to fall to 60% of the amount paid in 2012.</p> <p>DP 14-3 3.20: An example of a smaller firm assessing value and controlling costs - One of the smaller firms we visited had a strong culture of managing costs on behalf of their clients that came through in the broker vote. Investment managers gave careful consideration to monetary amounts they allocated to each broker based on their assessment of the value of the research used. The firm also provided challenge to their fund managers in the form of a peer-review to consider whether they were consistent in what they</p>

	<p>assessed as a value-added good or service and that they were focused on using commissions in the customer's best interests. This showed us that a firm's size is not a barrier to managing costs well.</p>
<p>"We did find examples where firms had successfully implemented considered budgets based on different factors (for example, an estimate of the cost of producing research internally or acquiring it from an independent research provider).</p> <p>We also saw instances where proposed research payments were benchmarked against various external sources to validate that investors were getting value for money and firms that switched to execution only trading as soon as periodic research budgets were met."</p>	<p>DP 14-3 3.20: An example where a firm was rigorously assessing the value of research - One firm had established an internal working group to assess the value of research separately from individual investment managers and set a budget per desk. This assessment did not attempt to value every report but instead the overall service provided from each broker to each investment desk. This then translated into a cap for the dealing desk at which point they would switch from CSA to execution only. This firm paid 10-15% less for research in 2013 than they did in 2012 and expects the payments to continue to fall to 60% of the amount paid in 2012.</p> <p>DP 14-3 4.12: ... Seeking a specific price for research as far as possible, or estimating what certain goods or services should cost. It was stated this was difficult, especially for unpriced broker research, but there were examples of efforts by some investment managers to: use internal estimates of their own costs; 'benchmarking' unpriced broker services against comparable priced services from independent research firms; and third party service providers helping investment managers to analyse commission payments to brokers compared to their peers for similar service levels.</p>
<p>"A number of firms had adopted a research poll where analysts and portfolio managers allocated votes that generated research payments based on percentages of the total research pot rather than specified monetary amounts."</p> <p>"We discovered that these firms' spending levels were closely correlated to trading volumes. Voting based on a percentage meant that analysts and portfolio managers were typically unaware of the value they were attributing to the research they had voted for."</p> <p>"They were therefore unable to assess value for money and couldn't demonstrate they were paying research providers appropriately using their clients' funds."</p>	<p>DP 14-3 3.18: The majority of firms relied on a broker voting process. The broker voting process ranks the brokers based on the investment manager's view of the research service(s) provided, but does not directly assess the monetary value of the research they are receiving.</p> <p>DP 14-3 3.19: We found that broker vote processes often lacked detail in recording what the fund manager was valuing when voting for a particular research provider. A 'vote' did not typically represent a specific monetary amount; instead it represented a percentage of the CSA balance. This meant that a broker could provide the same research in two periods and receive the same amount of votes, but be paid a different amount because trading volume had varied.</p> <p>DP 14-3 3.20: Some firms have a pro rata</p>

	<p>allocation of research votes to each investment team. The number of votes is proportionate to the volume of trades executed or amount of assets managed by that team, built on the assumption that if there is more volume or assets then there is a greater requirement for research. In some instances, firms have put caps or limits in place on the amount that can be spent with individual brokers or in total, but this is typically based on historical spend instead of an assessment of the value of the research provided by that broker. This means that if they have been paying more than they should in previous years then they will continue to over-pay and if the amount of the research used changed, the amount paid would not.</p>
<p>"In instances where records were kept, they usually did not contain sufficient information to establish that the service received met the evidential standards for substantive research."</p>	<p>DP 14-3 3.19: We found that broker vote processes often lacked detail in recording what the fund manager was valuing when voting for a particular research provider.</p> <p>PS14-7 1.9: We found the majority of investment managers had inadequate controls and oversight when acquiring research goods and services from brokers or other third parties in return for client dealing commissions. They were unable to demonstrate to us how items of research met the exemption under our rules and were in the best interests of their customers.</p>
<p>"Challenge and validation from front line management and control functions over the compliant use of dealing commission was commonly missing. We found similar control and oversight concerns during a 2016 review which looked at how investment managers oversee their best execution obligations."</p>	<p>DP 14-3 4.13: It was viewed that these combined features provide a fairly robust set of controls over the amounts spent through dealing commissions on research, and, to some extent, place a value on specific research goods and services received. However, in practice, our supervisory review found only two firms who were using most of these tools and achieving the kind of control and oversight we expect – and they were both closely involved in our review in 2012. This indicates a lack of progress by the wider market since we introduced our 2006 rules, even after several supervisory reviews.</p> <p>DP 14-3 4.28: ...Often there is no internal peer-review or secondary checks to ensure that similar judgements are being made across an investment management firm, and that only eligible research is being valued in line with our rules.</p> <p>DP 14-3 4.32: Overall, we still have concerns about the controls and oversight</p>

	<p>applied by investment managers on the amounts spent on research services paid from dealing commissions, and efforts to value research.</p>
<p>"Our review identified a few firms that had implemented systems and processes where detailed information was recorded on all substantive broker interactions. They were therefore capable of explaining the rationale behind research commission expenditure decisions and could confirm that these services met the evidential criteria for substantive research (COBS 11.6.5E)."</p> <p>"We expect to see clearly documented evidence to support the acquisition of permitted goods and services. In subsequent reviews we will also seek confirmation of boards demanding satisfactory management information on the subject. Firms are required to have adequate systems and record keeping processes (SYSC 3.2 and SYSC 9)."</p>	<p>DP 14-3 4.28: ... Record-keeping on what individuals are valuing in broker votes, potentially exacerbated by the lag in voting (which may only be carried out twice a year), results in a lack of clarity on what the investment manager has rewarded a research provider for over a particular period.</p> <p>SYSC 3.2.20: (1) A firm must take reasonable care to make and retain adequate records of matters and dealings (including accounting records) which are the subject of requirements and standards under the regulatory system.</p> <p>SYSC 3.2.21: A firm should have appropriate systems and controls in place to fulfil the firm's regulatory and statutory obligations with respect to adequacy, access, periods of retention and security of records. The general principle is that records should be retained for as long as is relevant for the purposes for which they are made.</p> <p>SYSC 9.1.1: A firm must arrange for orderly records to be kept of its business and internal organisation, including all services and transactions undertaken by it, which must be sufficient to enable the appropriate regulator or any other relevant competent authority under MiFID or the UCITS Directive to monitor the firm's compliance with the requirements under the regulatory system, and in particular to ascertain that the firm has complied with all obligations with respect to clients.</p>
<p>"Some firms failed to record details of corporate access meetings and in some cases, had to rely on estimates when responding to our questions.</p> <p>These findings suggest that this potential conflict and inducement risk is not being identified, monitored or managed effectively."</p>	<p>PS 14-7 2.14: As a third party, non-monetary benefit under COBS 2.3, the investment manager would need to satisfy themselves that the benefit does not impair their compliance to act in the best interests of their clients; disclose it clearly to the client; and, ensure the benefit enhances the quality of the service to their clients.</p> <p>If the investment manager does pay dealing commission to a broker in return for execution and substantive research goods and services, and the manager also attends Corporate Access meetings for 'free' facilitated by that same broker, the investment manager may want to consider ways to mitigate and manage any risk that</p>



	<p>they are subsidising Corporate Access that benefits the firm, with dealing commissions charged to the client. An investment manager's systems and controls over their dealing commission arrangements will be important in ensuring that they can demonstrate amounts paid to a broker are justified purely in relation to acquiring execution and substantive research goods and services permissible under COBS 11.6.</p> <p>DP 14-3 4.28: Record-keeping on what individuals are valuing in broker votes, potentially exacerbated by the lag in voting (which may only be carried out twice a year), results in a lack of clarity on what the investment manager has rewarded a research provider for over a particular period.</p>
<p>"In contrast, a few organisations attempted to partially mitigate the risk of indirectly paying for corporate access by paying for it from their own resources."</p>	<p>PS 14-7 2.17: ...only the disaggregated, eligible elements of a good or service can be paid for with dealing commission, while any remaining non-eligible parts can and should be paid for by other means, such as from the firm's own resources.</p>
<p>"Although many firms have embraced the use of commission sharing agreements (CSAs), the majority of research commission in our sample in 2015 was still spent on a 'fully bundled' basis (ie the executing broker was also the direct research commission recipient)."</p>	<p>DP 14-3 3.10: An investment manager may operate CSAs with different brokers, forming multiple pools of research commissions. Investment managers can then later allocate those balances according to which research providers they have used.</p> <p>DP 14-3 3.12: The benefit to investment managers of having a CSA in place is that it gives them more control over research payments, helping to separate the decision on who to execute with from whom to pay for research. It also enables payment to research providers that have not been traded with. Our work found that better practices generally involved CSAs.</p> <p>DP 14-3 3.13: CSAs can make it more straightforward for investment managers to exercise control over set research budgets and, once budgets have been reached, to switch to paying brokers only for execution.</p>
<p>"In some instances, firms were also unable to demonstrate that research and execution were treated as distinctly separate services."</p>	<p>DP 14-3 3.16: We found a number of investment management firms that were trading exclusively or predominately at bundled rates (e.g. without using CSAs). This makes it difficult for firms to pay an appropriate amount for the research they were using, as the research payment is integrally linked to the trading volume.</p>

	<p>DP 14-3 4.15: Our discussions support our supervisory findings that indicated that many investment managers still pay bundled, full service, execution rates with limited use of CSAs. There was a strong view that many investment managers make an arbitrary, notional split of a bundled dealing commission rate into 'execution' and 'research' to meet our disclosure requirements. It is clear that some investment managers have not fully separated their decisions (and internal governance) over trade execution and research, to consider appropriate prices for each distinct service.</p>
<p>"More work needs to be done by investment management firms to ensure they spend their customers' money with as much care and attention as if it were their own."</p>	<p>DP 14-3 2.11: In the report on our findings in November 2012, we highlighted our concerns that, despite spending millions of pounds each year through dealing commissions on execution and research, only a few firms we visited exercised the same standards of control over these payments that they exercised over payments made from the firms' own resources.</p>
<p>"Firms that have paid closer scrutiny to this area have generally seen a reduction in the dealing commission they spend on research, which feeds directly into better investment performance for their consumers."</p>	<p>DP 14-3 3.20: An example where a firm was rigorously assessing the value of research - One firm had established an internal working group to assess the value of research separately from individual investment managers and set a budget per desk. This assessment did not attempt to value every report but instead the overall service provided from each broker to each investment desk. This then translated into a cap for the dealing desk at which point they would switch from CSA to execution only. This firm paid 10-15% less for research in 2013 than they did in 2012 and expects the payments to continue to fall to 60% of the amount paid in 2012.</p>

**Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.**