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PUB REF: 004883

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Financial Conduct Authority

Policy Statement PS14/7

Changes to the use of dealing commission rules: feedback to CP13/17 and final rules

May 2014

Contents

In this Policy Statement we report on the main issues arising from Consultation Paper 13/17 *Consultation on the use of dealing commission rules*, and publish the final rules.

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You can download this Policy Statement from our website: www.fca.org.uk.

Abbreviations used in this paper

AFME	Association for Financial Markets in Europe
AIFM	Alternative Investment Fund Manager
COBS	Conduct of Business Sourcebook
CP	Consultation Paper
EU	European Union
FCA	Financial Conduct Authority
FSA	Financial Services Authority
IMA	Investment Management Association
MiFID	Markets in Financial Instruments Directive
PS	Policy Statement
UCITS	Undertakings for the Collective Investment of Transferable Securities

1. Overview

Introduction

1.1 This Policy Statement (PS) summarises feedback from CP13/17 on proposed changes to our use of dealing commission rules and publishes our final changes to COBS 11.6 (Appendix 1). We have made small amendments to the final rules and guidance, and we also provide some clarifications in this PS as to the intention of our changes. However, we have decided to proceed with the main elements of the original proposals.

1.2 This PS does not comment on views expressed to us both in meetings and in responses to CP13/17 on the potential need for wider reform to the regime in the medium term. We will consider and comment on these as part of a further update later this year. This will report back on the findings of our thematic supervisory work and discussions from the series of roundtables hosted by the FCA with both buy-side and sell-side firms, carried out between November 2013 and February 2014.

1.3 As we set out in CP13/17, this wider supervisory work and open debate is taking place within the context of ongoing EU discussions on revising the Markets in Financial Instruments Directive (MiFID). We still prefer to consider any wider reforms through the discussions in MiFID II, to ensure a consistent EU-wide approach. We anticipate we will have to reflect the final MiFID II proposals in our domestic rules to take effect by late 2016 or early 2017.[1] If we were to consider any additional changes on a UK-only basis we would also seek to introduce this at the same time as applying MiFID II, in order to minimise the burden on firms.

Who does this affect?

1.4 This PS will be of direct interest to:

- 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

1 Depending on the final requirements in MiFID II, we may also need to consider our approach to non-MiFID investment management activity falling under the UCITS or Alternative Investment Fund Managers Directives, subject to any wider EU discussions on harmonising standards across these areas of legislation.

- retail investors who have investments in retail funds (which may be through a wrapper such as an Individual Savings Account (ISA)), or who have a direct relationship with an investment manager, for example individuals with discretionary-managed investment portfolios

1.5 It will also interest relevant trade associations, brokers (including investment banks), and providers of services such as market data services and independent research.

Is this of interest to consumers?

1.6 As set out in CP13/17, this PS will be of direct interest to institutional investors, such as the trustees of pension funds. It will also be relevant to retail fund trustees and depositaries, investors in retail products and the providers of these products – such as unit trust managers, authorised corporate directors, other investment companies (including investment trusts) and life assurance companies.

1.7 Although the proposals clarify existing expectations under our rules, rather than create new requirements, they may drive behavioural change by encouraging investment managers to improve controls over their use of commissions. This may result in a reduction in costs passed to the customer's funds. It may also improve transparency, so investors are more aware of how much they are paying in dealing commission costs.

Context

1.8 At the FCA's Asset Management Conference in October 2013, we set out our intention to review the use of dealing commissions by investment managers. We want to ensure investment managers seek to control costs passed onto their customers with as much rigour as they pursue investment returns.

1.9 The proposals in CP13/17 were intended to clarify areas of our existing rules in COBS 11.6 following specific issues highlighted in our thematic supervisory work and Dear CEO letter on conflicts of interests in asset management published in 2012.[2] 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.

1.10 One example was the service provided by brokers or other third parties of arranging or bringing about contact between an investment manager and an issuer or potential issuer ('Corporate Access'). None of the investment managers we visited could justify to us how Corporate Access met the evidential criteria for research under our rules to allow them to pay for it with dealing commissions.

1.11 Investment managers must ensure they act in compliance with our rules in COBS 11.6. This includes ensuring they 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 customers when deciding whether to pass on charges to their clients.

2 FSA Report, *Conflicts of interest between asset managers and their customers: identifying and mitigating the risks*, November 2012. Source: www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf

1.12 The finalised changes in this PS will 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. This should ensure the use of commissions is interpreted correctly as 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' funds.

1.13 In parallel to CP13/17, we have also been carrying out policy discussions on the potential need for wider reforms and thematic supervisory work including visits to both investment managers and brokers. We have also engaged with independent research firms, other service providers, and corporate issuers. As noted above, we will report back on this work later in the year.

Summary of feedback and our response

1.14 There was general support for our intended outcome as stated in CP13/17, to ensure investment managers control the costs from the use of dealing commission appropriately, and ensure the goods and services acquired in return for commissions meet our rules and are in the best interests of their customers. Most respondents agreed with the principle that investment managers should apply a similar level of scrutiny to payments for goods and services using client dealing commissions, as they would if they were spending the firm's own money.

1.15 Responses on the detail of our proposed changes were more varied. A number supported the proposals as meeting the desired outcomes. Others were supportive, but sought further clarification on the technical aspects in the draft Handbook instrument, or on statements made in CP13/17. Others challenged aspects of the changes. A brief summary of the main themes in responses asking for clarification or challenging our proposals is provided below, with more detail in Chapter 2.

Amending the exemption permitting the use of dealing commission and the criteria for 'substantive' research

1.16 There was some support for the changes to the rule in COBS 11.6.3R that provides the exemption to the prohibition on the use of dealing commissions, and the criteria for substantive research in COBS 11.6.5E. However, there were equally some concerns that the proposals represented a more significant change, altering the burden of proof. Some also felt the evidential criteria for substantive research were being made unduly narrow, and questioned the need for research to "present…a meaningful conclusion." We clarify in our response below that we do not see the change to the rule and evidential provision as marking a significant departure from the standards of compliance and record keeping we would expect compliant firms to already have in place.

1.17 We have provided some further explanation on the criteria for substantive research in response to requests for clarification, but have decided to finalise the changes largely as proposed in CP13/17. We have also kept the reference to 'meaningful conclusions', and note that this has always been part of the criteria for research under the existing rules introduced in 2006. We continue to believe that substantive research should present the investment manager with meaningful conclusions based on analysis or manipulation of data, since this is a key feature that distinguishes substantive research from other, more general information services that should not be paid for with dealing commissions.

Corporate Access

1.18 Most respondents supported our approach on the use of dealing commissions to pay for Corporate Access, and agreed with our view that it is not substantive research. Some suggested that the definition proposed may be too widely drawn. Others accepted the definition, but requested further explanation as to how investment managers should treat a situation where Corporate Access is provided in a bundled form alongside an element of substantive research that can be paid for with dealing commissions.

1.19 In response, we set out our reasons for maintaining the proposed definition of Corporate Access. However, we have taken steps to explain our expectations where firms receive Corporate Access as part of a bundled service including the provision of substantive research. We have also improved and clarified the drafting of the final guidance on making mixed-use assessments, which is equally relevant to this situation.

Mixed-use assessments

1.20 In addition to comments on the provision of Corporate Access alongside substantive research services, there were requests to make clear whether the FCA viewed mixed-use assessments as equally applicable to non-priced, bundled goods and services. Some respondents argued that the guidance proposed at COBS 11.6.8AG could be read to imply that we were only indicating such assessments needed to take place for priced bundled services. There were also a few comments raising concerns that mixed-use assessments are difficult to conduct and this may lead to divergent approaches in 'valuing' elements of a bundled good or service by market participants over time.

1.21 We have made minor changes to improve the guidance included under COBS 11.6.8AG in response to comments, and have added wording to make it explicit that mixed-use assessments are equally applicable to non-priced, bundled goods and services. We recognise such assessments will not always be straightforward and firms may apply different approaches. However, we do not want to mandate methodologies for firms. We do expect investment managers to show evidence of their processes and the basis of their judgements to demonstrate such assessments are done with the best interests of their customers in mind.

1.22 Over time, we would expect to see a convergence of market practices in this area, which trade associations may help encourage by seeking to develop or share best practices among their members in making mixed-use assessments.

Scope and cost benefit analysis

1.23 Those responses that expressed the view that we had altered the evidential basis of the rule permitting the use of dealing commission tended to also challenge our CBA in CP13/17. They argued that the changes proposed would add new costs to firms, in contrast to our CBA, which determined that there would be no material additional costs to firms that already complied with our existing rules.

1.24 Having carefully considered these responses, we believe our original CBA assessment remains sound. Firms should already have in place sufficient systems and controls to be able to demonstrate to us that they are meeting the existing rules, including that services acquired with dealing commission meet the exemption and criteria for research. Our baseline includes relevant publications that have previously set out our expectations to firms. We maintain our view that the amendments proposed in CP13/17, and subject to the further clarifications in this PS and the final proposals, do not materially alter the costs or burden on firms that are already compliant with the current rules. We will continue to take a proportionate and risk-based approach to supervising and, where necessary, enforcing our rules.

1.25 Others asked for clarity on the territorial effect of our rules. However, since the changes proposed to COBS 11.6 have not altered the existing application of COBS, and will in any case depend on the precise business models and structures of individual firms, we have not addressed this issue in this PS.

Next steps

What do you need to do next?

1.26 Investment managers should review the finalised changes to our Handbook set out in Appendix 1. These changes will take effect on **2 June 2014**.

1.27 We believe firms that are already complying with our rules will not need to make significant changes. However, firms may wish to reflect changes to the wording of our existing rules and new guidance in their internal policies and procedures.

1.28 If firms have any comments on this PS, they can write to us using the contact details on page 2.

2. Summarising feedback and our response

2.1 We received 62 formal responses to CP13/17.[3] This chapter provides a detailed summary of the main points raised in the submissions received, and our responses to them following careful consideration. We also note any key changes or clarifications made to the final rules and guidance compared to the proposals in CP13/17. Responses have been grouped by theme, rather than corresponding to the three broad questions posed by CP13/17, as this reflects the way in which most comments were structured.

2.2 Most responses welcomed the FCA's examination of the issues in this area and welcomed our desire to provide more clarity and guidance. The vast majority also agreed with our desired outcome of ensuring investment managers, as trusted agents acting on behalf of their clients, seek to control costs passed to investors with the same degree of rigour as they pursue investment returns. There was acceptance of the principle that an investment manager should be expected to exercise a similar degree of oversight and scrutiny in using client dealing commission to acquire goods and services, as they would if they were spending the firm's own money. The remainder of this chapter examines the more detailed comments received on the proposed changes and their potential impact.

The exemption permitting the use of dealing commission and 'reasonable grounds'

2.3 In the CP, we proposed changes to COBS 11.6, removing wording to the effect that an investment manager "should have reasonable grounds to be satisfied" that goods and services acquired with commissions constitute either the provision of research or are related to the execution of trades.[4] A number of responses viewed this change as recalibrating the regime to one of 'strict liability', removing the scope for an investment manager to exercise careful judgement.

2.4 As a consequence, some respondents believe the proposed changes would increase the level of due diligence and record keeping a firm would need to undertake to satisfy us that they are acting in compliance with the rules. A number feel this is inappropriate given that the question of what constitutes the provision of substantive research, in particular, will involve an element of judgement by an investment manager. For example, the extent to which research 'adds value' or has 'meaningful conclusions' may depend on the specific investment strategy a manager is pursuing on behalf of their clients.

2.5 There was also a view that a 'strict liability' reading of the rule would exacerbate issues where an investment manager may not have clarity from a broker or third party service provider of the full content of a good or service being provided to them. Some expressed concern that this may lead to an investment manager potentially breaching our rules despite taking reasonable steps to determine that the content of a good or service is substantive research at the point of accepting it from a broker or third party.

3 See Annex 1 for a list of the names of non-confidential respondents.

4 This included redrafting COBS 11.6.3R(2), COBS 11.6.4E and COBS 11.6.5E.

Our response

An investment manager must have reasonable grounds to be satisfied that a good or service paid for with dealing commissions will reasonably assist them with the service provided to their customers; receipt of the good or service must not impair their duty to act in their customer's best interests; and the good or service must either be directly relation to execution or amount to the provision of substantive research. In order to ensure these three limbs of the exemption are explicitly clear, we have deleted COBS 11.6.3R(2) and re-drafted it as COBS 11.6.3R(3). Firms that may not be compliant in their current practices should take steps to ensure they meet our rules from now on.

We have retained the requirement that an investment manager must have 'reasonable grounds to be satisfied' that a good or service received in return for dealing commissions 'will reasonably assist' them in providing its services to its customers, in response to comments received. This recognises the fact that substantive research may vary in its relevance to a manager's day-to-day investment or trading decisions (and may include decisions not to trade or invest), especially where a service is received over a period of time.

We do not believe the removal of 'reasonable grounds' in relation to both whether the investment manager's receipt of a good or service impairs compliance with the duty to act in the best interests of customers, and whether a good or service is either directly related to the execution of trades or amounts to the provision of substantive research, represents a significant change. We believe the assessment required to comply with both points is essentially an objective consideration. The first point is now more closely aligned to the requirement under COBS 2.3.1R(2)(a). Consideration of the second point will be based on the facts as assessed against the criteria in the evidential provisions. FCA supervision of this part of the rule would continue to focus on whether an investment manager's receipt of any good or service that did not meet the evidential criteria had been based on a reasonable assessment in the first instance.

We expect firms to have sufficient systems, controls and record keeping in place to enable the firm to meet and demonstrate compliance with our regulatory requirements. As we stated in the original consultation on these rules in 2005: "For all research services, investment managers should be able to justify, both to ourselves and to their clients, their decision to acquire a particular service with dealing commission and why it is a research service."[5] We also strongly emphasised this point in our conflicts of interest review in 2012, where we found that few firms could demonstrate to us how they met our rules in COBS 11.6. As a result, we have decided to made this explicit in final guidance at COBS 11.6.20G.

We have also retained the status of COBS 11.6.4E and COBS 11.6.5E as evidential provisions, while adding the presumption of contravention clause. This means it does not exclude the possibility that a good or service (or element of a good or service) may not meet a precise, strict reading of the criteria in COBS 11.6.5E(1), but could still amount to substantive research. However, we would not expect

5 FSA Consultation Paper 05/5 on Bundled brokerage and soft commission (March 2005)

this to occur frequently. The contravention clause is intended to ensure firms properly consider whether a good or service meets the cumulative criteria for substantive research or is directly related to the execution of trades.

The evidential criteria for substantive research

2.6 A number of respondents supported the proposed changes to emphasise the 'substantive' nature of research and expressed the view that investment managers should only pass on charges for research that adds real value to their decision-making on behalf of clients. Such responses suggested the emphasis on substantive content would drive the market for research towards higher quality outputs, and reduce payments for lower value-added, poor quality research, reducing over-production – to the benefit of most market participants and their customers.

2.7 However, by contrast, there were also strong views that felt changes in particular to COBS 11.6.5E(1)(d) went beyond a clarification. Some believed the use of "present" in conjunction with "meaningful conclusions" implied only written research would be able to meet the criteria. Others took the opportunity to express concern that "meaningful conclusions" would create unnecessary attempts by market participants to add explicit 'concluding' remarks simply to meet the criteria. A minority also queried whether an investment manager had to agree with or follow the conclusion in their actual investment decision in order for it to be "meaningful" and meet the criteria.

2.8 Other responses felt the changes were broadly acceptable, but desired some further clarity from the FCA over specific items such as telephone calls, for example from a broker's research analyst or equity sales employees. It was argued that, by its nature, a telephone call may not always be as easily assessed against the criteria and may have less in-depth content compared to a written report. It was suggested that these could still be capable of qualifying as substantive research, especially when provided as part of a broader, ongoing research service.

Our response

The reference to 'meaningful conclusions' under the criteria for research that can be acquired with dealing commission has been present since the rules were first introduced – it was not a new addition proposed in CP13/17.[6] We continue to believe a "meaningful conclusion" is an essential element of third party research that can be paid for with dealing commissions.

The change to COBS 11.6.5E(1)(d) is not intended to limit a conclusion to a 'buy' or 'sell' recommendation. A conclusion can include a summary and statement of opinion, or making a reasoned deduction or inference, provided that the research contains this in itself. However, in accordance with the spirit and intention of the rules, we would not expect an investment manager to accept as substantive research a good or service that only has a purely 'artificial' conclusion added by a broker or third party, which some respondents suggested may occur in response to our changes.

6 The criterion that research must have a meaningful conclusion is stated in past FSA publications, including CP05/5, in paragraphs 2.22-2.28 and PS04/23, in paragraphs 2.22-2.25.

The criteria for substantive research continue to be neutral in terms of the format in which it is provided.[7] The insertion of 'present' at COBS 11.6.5E(1)(d) does not exclude non-written formats, since it is common to verbally present a finding. Telephone conservations may present a 'conclusion' as easily as a written report. It is for the investment manager to make a judgement whether, for example, the content of a call from a broker can meet the criteria.

By contrast, the investment manager may assess certain communications from brokers or third parties as not having sufficient substantive content to meet the cumulative criteria for substantive research. In practice, there may be many instances of circulars or other communications received by an investment manager which they consider are not capable of adding value to their investment or trading decisions; do not present any new, original thought (but only refer to existing reports and market information); and / or consist of such general observations that it is not deemed to have intellectual rigour and present meaningful conclusions.

The phrase 'meaningful' does not infer that the investment manager has to agree with and follow the conclusions to render it substantive research. We fully accept that third party research may be valuable to an investment manager precisely because it reaches an opposite, contradictory conclusion to their own thinking. However, firms should also consider whether an item will reasonably assist them in providing its services to their customers, to ensure substantive research has some relevance – which is discussed in more detail below.

As we noted in CP13/17, the exemption allowing investment managers to acquire goods and services with dealing commission was designed to be relatively narrow and consistent with a firm's duty to act in the best interest of their customers. We expect the rules, evidential provisions and guidance to be read purposively in this respect.

2.9 There were several responses that queried whether external research that meets the criteria in COBS 11.6.5E, but is used by an investment manager primarily to feed into their own further research, or at an initial filtering stage of potential investment ideas, is still acceptable to be acquired with dealing commissions. This concern was mainly caused by paragraph 2.14 of CP13/17, which some felt indicated that substantive research that did not immediately trigger an investment or trading decision by the investment manager, but instead contributed to their own further thought and internal research, may not be acceptable.

Our response

The points raised in paragraph 2.14 in CP13/17 were not intended to rule out research that is used by the investment manager to feed into their own further research or assessment of investment and trading ideas. Our main intention was to clarify that a good or service that does not meet the criteria in COBS 11.6.5E, but may feed into an investment managers' own internal research, does not become research by virtue of its later application. For example, a data set that has not been manipulated to reach meaningful conclusions, or

7 We would note that the criterion at COBS 11.6.5E(1)(b) clearly states "whatever form its output takes[…]."

items excluded under COBS 11.6.8G, do not *become* substantive research if the investment manager applies their own conclusion based on that data or information, where it did not otherwise contain one, or builds it into their own research.

Where the investment manager is satisfied that third party research meets the criteria for substantive research in 11.6.5E, including COBS 11.6.5E(1)(a) (which may be particularly relevant), it may be acceptable even if it is mainly used to inform further internal research. In this context, an investment manager must also consider whether research used to inform internal research will 'reasonably assist' them in providing the service to the customers to whom they are passing on the charges.

If an investment manager receives research that will never be used at all, even if it could meet the criteria for substantive research, this would not 'reasonably assist' the investment manager. Accepting such a good or service in return for dealing commissions in this case would also appear to be inconsistent with their duty to act in the best interests of their customers – therefore it should not be charged to them.

Corporate Access

Definition

2.10 Most responses supported the view that it should not be permissible to pay for Corporate Access through the use of dealing commissions. However, some respondents believe the definition of Corporate Access proposed was too wide, encompassing the arranging of any potential contact between an issuer or potential issuer and an investment manager.

Our response

We welcome the support for our position that Corporate Access does not meet our criteria for research and therefore should not be acquired in return for dealing commission under our rules.

We believe the definition of Corporate Access remains appropriate for its application in COBS 11.6. The definition denotes the service of arranging or bringing about contact between an investment manager and an issuer or potential issuer. Alternative definitions proposed by some respondents did not appear to capture the various forms of meetings that may be intermediated, which are unlikely to constitute substantive research that could be paid for with dealing commissions. We comment on situations where Corporate Access may be combined with other services below.

Corporate Access as part of a bundled service

2.11 A number of responses mentioned a related point to the above, which was a request for guidance or clarification around the approach the FCA would expect an investment manager to take where contact with a corporate issuer was provided as part of a wider event or service (i.e.

under a 'bundled' arrangement). Examples included investor industry conferences or investor field trips (such as a visit to a business site of an issuer or potential issuer) arranged by a broker or third party.

Our response

We recognise that Corporate Access is used by market participants to denote a wide variety of services. In the CP, we did acknowledge situations where Corporate Access may be provided alongside a substantive research element, stating that, in such instances, "only that limited research element (which should be ascribed a reasonable, fair value by the manager) should be paid for out of dealing commissions, not the entirety of the arranging service."[8] We recognise that, in the initial guidance proposed on mixed-use assessments (at COBS 11.6.8AG), we could have been clearer on the application to an unpriced bundled good or service with both substantive research and non-research components, not just priced bundled services. We have therefore amended and expanded our guidance at COBS 11.6.8AG in the final instrument (see Appendix 1).

We are aware that an investment manager may commonly attend investor conferences arranged by a broker, which involve both a number of sessions with corporate issuers (which would constitute Corporate Access), but also, as assessed by the investment manager, the presentation of some substantive research by a broker's analyst or an industry expert. Likewise, during an investor field trip, the investment manager may receive a report or verbal briefing from the arranging broker or third party that constitutes substantive research. In each case, the investment manager should take steps to identify and disaggregate the discrete element of substantive research within this bundled service, from any non-eligible elements such as Corporate Access, and make a fair assessment of the charge it should pass on to their customers through dealing commissions for the acceptable part.

The final guidance at COBS 11.6.8AG(1)(b) and COBS 11.6.8AG(2)(b) will also be relevant to goods or services bundled with Corporate Access. For example, an investment manager could consider performing a fact-based analysis of the substantive research element where it is provided in an unpriced bundled service with Corporate Access. They could also consider what the firm would be willing, in good faith, to pay for the non-eligible Corporate Access element. This should help the investment manager to determine a fair charge to pass to their customers through dealing commission for the substantive research in this bundled context, which does not cross-subsidise the non-eligible element. Receiving substantive research shortly before or after Corporate Access, such as meeting an issuer or visiting their business site, should not affect the investment manager's fair assessment of the charge for the substantive research they may subsequently pass on to their customers.

An investment manager can still choose to pay for other, non-eligible elements of a conference or field trip, such as Corporate Access, other than through dealing commission. This will be a commercial decision for the firm. For example, to facilitate Corporate Access outside the UK, a broker may draw on

8 CP13/17, paragraph 2.28.

the knowledge of their analysts to arrange a meeting. Since this is part of the Corporate Access service, the investment manager should not pay for this with dealing commissions. However, if the broker and investment manager agree that a form of arrangement or introducer fee is appropriate to compensate the broker, an investment manager may decide to pay this fee from their own resources.

Corporate Access as a non-monetary benefit

2.12 A final query raised by several responses on Corporate Access concerned the treatment of attendance at an issuer roadshow or a meeting with an issuer, where an investment manager genuinely views the meeting as free, but it has been notionally 'arranged' by a broker. The scenario generally described was one where:

- an investment manager already has a shareholding in a corporate issuer or is known to the issuer as a potential investor (for example, due to the investment manager's size or particular research focus on the company)
- the issuer would ordinarily be willing to meet with the manager directly (and may previously have done so), and
- when that corporate issuer happens to be on a roadshow organised by a broker, the investment manager, for convenience, meets the issuer at that roadshow event

2.13 Respondents outlining this situation argued that the effect of the above is that COBS 11.6.3R(1)(c), which stipulates that the prohibition on the ability to receive goods and services is only relevant where they are *offered in return for dealing commissions*, would not be activated if they demonstrate the Corporate Access is not provided in return for any dealing commission paid to the broker.

2.14 Those responses questioned whether it may be acceptable for the investment manager to both inform the broker they will not pay for this type of access in any form, and where they nevertheless meet a corporate issuer in this context, to consider the receipt of this service under the general inducements rules in COBS 2.3. 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.

Our response

We acknowledge that the scenario set out above may be a situation encountered by some investment managers. Indeed, following the thematic supervisory report and Dear CEO letter in November 2012, some responses to our letter have involved investment managers formally communicating to a broker that they do not and have not paid dealing commissions to them in return for receiving Corporate Access.

In such situations, we would expect investment managers at all times to consider and comply with the relevant requirements in COBS 11.6, COBS 2.3 and SYSC 10, and be able to demonstrate to us that they have acted consistently with our rules.

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 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.

We have also examined the provision of Corporate Access by brokers and third parties in more detail as part of our thematic supervisory work looking at the wider use of dealing commission regime, including considering any potential conflicts of interest concerns in this area. We have also engaged with corporate issuers. We will comment on this when we report our wider review findings.

Investor stewardship

2.15 A small number of recipients queried the FCA's reference to investor stewardship alongside Corporate Access. They felt that linking the two terms may imply that the FCA believed wider investor stewardship activities, which may include research that focuses on the corporate governance and long-term strategy of an issuer, do not have the potential to amount to substantive research that can be paid for with dealing commissions.

Our response

We wish to be clear that research focused on investor stewardship issues, such as the quality of corporate governance within a corporate issuer or looking at an issuer's strategic objectives and the sustainability of its business model, could be capable of meeting the criteria under COBS 11.6.5E. It remains for the investment manager to determine whether a given good or service meets the criteria for substantive research in each case.

Guidance on mixed-use assessments

2.16 A common theme in responses on mixed-use assessments related to instances where Corporate Access is provided alongside substantive research as a bundled service, as discussed above. Others also questioned why our proposals for new guidance on mixed-use assessments at COBS 11.6.8AG appeared to focus on disaggregating a *priced* bundled service, but did not seem to address bundled, *unpriced* goods or services. These responses argued that a mixed-use assessment was equally – if not more – important for a bundled, unpriced good or service that contains both substantive research and non-research elements.

Our response

We have added an additional paragraph to the final guidance at COBS 11.6.8AG to explicitly address this point (see Appendix 1).

2.17 There were also several comments indicating that the drafting of COBS 11.6.8AG(2) was slightly unclear. Respondents argued that the guidance implied that having disaggregated eligible from ineligible elements, and valued and charged eligible items through dealing commissions, the remaining ineligible items could not be paid for by other means. Respondents assumed this was probably not our intention.

Our response

We have amended the final guidance at COBS 11.6.8AG(2) to clarify the provision in response to this point. As respondents suggested, it was not our intention to imply that, once a bundled good or service has been disaggregated, that any non-eligible elements cannot be paid for at all. Instead, it was intended to make clear that 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.

2.18 Other comments stated that without a common methodology, firms would take quite different approaches to both mixed-use assessments and the valuation of unpriced goods or services – even when valuing the same good or service. Some called for the FCA to set out a preferred 'methodology' for mixed-use assessments. The same responses on this point also suggested that investment managers needed greater cooperation and information sharing from sell-side brokers, or other third party service providers, in order to allow them to make effective mixed-use assessments.

Our response

We have sought to address comments around the difficultly of valuation where a distinct price is not provided by adding further guidance at COBS 11.8.6AG(1). We indicate that investment managers should seek to make a fair assessment of the charge to be passed to their customers in these cases. To help make this assessment, we have suggested firms could consider making a fact-based analysis, using reasonable proxies such as comparable, priced goods or services available elsewhere in the market, or making an estimate of what their own costs would be in providing a similar good or service internally. We are aware some investment managers already take such an approach.

We also provide further guidance on alternative approaches a firm may wish to take when making mixed-use assessments at COBS 11.6.8AG(2). We suggest that where an investment manager is assessing a mixed-use good or service, they may also consider what they would be willing, in good faith, to pay for the non-eligible items, to ensure they do not subsidise the costs of these items for the firm by over-valuing an element that can be paid for by the client through commissions. Where alternative fair assessments can be justified in terms of the charge for the element of a bundled good or service that meets COBS 11.6.3R(3) and could be passed on to customers, the investment manager should consider which approach would be in the best interests of their customers.[9] We would

9 For example, firms should seek to mitigate the conflict of interest risk in any methodology they use, to ensure it does not apply a excessive high value to the elements of a good or service that meet COBS 11.6.3R(2) and can be passed onto the customer, which could be seen to subsidise the remainder of a bundled good or service that benefits the firm in their day-to-day activities and operations.

also remind firms of the expectations we set out in the 2008 thematic review of these rules on making mixed-use assessments, especially relating to market data services, which remain relevant.[10]

Otherwise, in terms of methodologies, we believe this should remain a matter for firms to decide, based on their own business arrangements and, for example, their approach to the use and consumption of third party research. Provided firms can evidence to us that they have a clear, rational process that puts a strong emphasis on ensuring their customers' best interests are central in their assessment of both the eligibility and amount that should be paid from dealing commissions, versus the firms' own resources or by other means, this should be acceptable.

Where an investment manager feels they need information from the broker or third party provider to assist them in a valuation process, we would expect a reasonable level of transparency to be present as part of any commercial arrangement. This could include the nature of a good or service provided, and the extent to which it has been used. However, it remains for the investment manager to ensure they meet the requirements in COBS 11.6 and can adequately demonstrate this to us.

Other comments

Territorial scope and interaction with other regulatory regimes

2.19 Several responses queried how COBS 11.6 should be applied in cross-border business. Examples included where the investment manager delegates the management activity, or executes orders, in another jurisdiction. Some also identified the challenge of differences between the UK and US approaches, especially where client orders may be aggregated to achieve better execution.[11] In this case, dealing commissions on a US trade, for example, could be used to pay for items which are allowed under the US Securities and Exchange Commission (SEC) guidance but would not meet the evidential provisions in COBS 11.6.[12]

Our response

The changes proposed in CP13/17 do not affect the existing territorial application of COBS. Firms with global activities must already consider the application of our rules to their business activities. Specifically, with regard to COBS 11.6 on the use of dealing commissions, there have been variations in our approach compared to other jurisdictions (such as the US) since we first implemented our rules in January 2006. We would be concerned if firms operating in the UK have not recognised this in their existing operations. Similarly, if an investment

10 FSA Report, *Use of dealing commission – results of a thematic review* (January 2008), particularly paragraphs 3.20-3.28. Source: www.fsa.gov.uk/pubs/other/Dealing_Commission.pdf

11 The US SEC issued an 'Interpretive Release' in July 2006, interpreting a statutory safe-harbour relating to the use of dealing (or 'soft') commissions to acquire additional goods and services from brokers under Section 28(e) of the US Securities and Exchange Act 1934.

12 Some key differences include that fact we do not believe items such as post-trade analytics or Corporate Access can constitute execution or research under our use of dealing commission rules, whereas the SEC guidance allows these items in their broader approach.

manager had previously made a different judgement on paying for Corporate Access than the position we set out in November 2012, we would expect firms to have implemented changes by this stage.

In the UK, the ability to use dealing commissions to acquire research is not intended to cover all non-execution related inputs into the investment manager's decision-making process, but only additional third party research that can met our cumulative evidential criteria. This seeks to minimise the conflicts of interest for investment managers, by reducing the possibility that they can subsidise significant, core costs of business through dealing commission charges passed on to their customers' funds.

However, as set out in our Supervision manual, we will continue to have regard for the context in which a firm operates where it undertakes business internationally.[13]

Developing a taxonomy of goods and services

2.20 Several responses indicated that it may be useful for industry trade associations, or the FCA, to develop a common taxonomy of the types of goods and services generally provided by brokers or third parties to investment managers, indicating whether these are likely to constitute the provision of substantive research.

Our response

We are not minded to produce a detailed taxonomy of goods and services nor suggest that particular groups of products are acceptable or otherwise under the use of dealing commission rules, beyond the indication of non-permitted items as currently set out at COBS 11.6.6G-11.6.8G. We believe a more detailed taxonomy or list may lead to a 'box ticking' approach by investment managers, which would undermine our desire for improved controls and oversight in assessing both the nature of a good or service received, and, if it is eligible, whether the costs passed to their customers in relation to it are justified.

It would also equally risk brokers or other third parties seeking to 'label' a good or service – perhaps superficially – as constituting a certain type of good or service to enable or encourage an investment manager to acquire it using client dealing commissions. Clearly, we would be concerned at any attempts to unduly influence investment managers in making a proper assessment of whether a good or service meets the exemption in the use of dealing commission rules.

If firms or trade associations, such as the Investment Management Association (IMA) and the Association for Financial Markets in Europe (AFME), wish to develop a common taxonomy of goods and services to aid their members, we would be open to engaging with such an initiative. However, any output should be consistent with the spirit of our rules, and consider the issues noted above.

13 SUP 1A.2.2G. There are also provisions in COBS, PERG and SYSC which consider territorial application and issues such as formal delegation by a firm of their activities.

Annual attestations

2.21 Several responses proposed the idea of a regular, annual attestation from the CEOs of investment managers to the FCA similar to the Dear CEO letter on conflicts of interest in November 2012. Those suggesting this approach argued it would ensure investment managers remained focused on this area going forward, and would give the FCA clearer supervisory oversight of firm arrangements.

Our response

We do not propose to explore this option in the final rule changes at this time. Typically, the FCA uses Dear CEO letters and attestations to raise areas of specific concern to firms and seek assurances they have reviewed their business operations, often as a result of our thematic supervisory work. We would need to carefully consider the possible impact and effectiveness of using an attestation as a standard requirement in this specific area. For example, one consideration would be whether it may create an unnecessary burden for investment firms.

As mentioned above, an investment manager should already have adequate systems and controls, including record keeping, to be able to demonstrate to us that they are acting in compliance with our rules. To ensure this requirement is not overlooked, we have added guidance to this effect at COBS 11.6.20G.

3. Concluding remarks

3.1 This chapter summarises our expectations of firms and the implementation timing of the rule changes. We also summarise next steps, given our wider work and discussions on the use of dealing commission regime.

Implementation and our expectations of firms

3.2 The final rules are published alongside this Policy Statement (see Appendix 1). The amended rules and new guidance provisions will take effect from **2 June 2014**.

3.3 We believe firms that are already compliant with our existing rules and have sufficient systems and controls to demonstrate compliance should not need to make material systems changes under the amended provisions. We will also continue to take a proportionate, risk-based approach to our supervision of firms and, where we find breaches of our rules, we would similarly consider any enforcement action on a proportionate basis.

3.4 These clarifications and changes should ensure firms apply a similar level of controls, oversight and accountability in spending client dealing commissions and assessing value of goods and services obtained with this money, as they would if they were spending the firm's own money. While we know many firms do seek to place their customers' best interests at the heart of their businesses, they must ensure this is followed through in practice in areas such as the use of dealing commission to maintain the level of trust UK investors place in them to look after and grow their assets.

3.5 We believe the UK can maintain and enhance its global attractiveness as a thriving centre for asset management by demonstrating an unrelenting focus on managing costs and improving transparency, while still achieving strong performance.

Next steps

3.6 Following the FCA Asset Management Conference in October 2013, we have been engaging widely with stakeholders in an open debate to consider whether the use of dealing commission regime is fit for purpose in the longer term. This has included a series of roundtables and bilateral meetings held at the FCA, which allowed us to engage with over 130 firms and trade bodies. We also invited wider comments on this debate in CP13/17, in addition to feedback on the immediate changes proposed.

3.7 We have also carried out a thematic supervision review examining both buy-side asset managers and sell-side brokers to review current market practices and business models linked to the use of dealing commissions, with visits to firms occurring from November 2013 to February 2014. In addition, we spoke to independent research providers, other third party service providers, and a sample of corporate issuers.

3.8 This debate and work has been framed in the context of ongoing EU negotiations to revise MiFID. MiFID II has the potential to impact the ability of portfolio managers to receive third party inducements, which may include research acquired in return for dealing commissions linked to execution services. We have continued to monitor and engage with EU discussions on revising MIFID, and we see our domestic work and discussions on the use of dealing commissions as part of informing this debate on future EU reforms. We are also actively engaging with other international regulators through the International Organisation of Securities Commissions (IOSCO).

3.9 We expect to report back on our wider work later in the year, by which stage there may also be further clarity as to the potential extent of the MiFID II reforms and their impact on the ability for portfolio managers to use dealing commission arrangements to acquire additional services from third parties, such as research. We will indicate our views on what further change we believe may be appropriate based on our findings and any developments in MiFID II. If we do identify a need for further reform, we will look to align the timing with our domestic implementation of MiFID II in late 2016 or early 2017, to minimise the uncertainty and potential cost of any changes for firms.

Annex 1
List of non-confidential respondents

We received 62 responses in total to CP13/17. The names of firms or individuals who submitted non-confidential responses are listed below:

Alternative Investment Management Association (AIMA)

Amundi

Asia Association of Independent Research Providers (AsiaIRP)

Association for Financial Markets in Europe (AFME)

Association of British Insurers (ABI)

Atlantic Equities LLP

Autonomous LLP

Baillie Gifford & Co.

Barclays Bank Plc

Berenberg UK

BlackRock

Bloomberg LP

Cartesian Capital Partners

Churchill Wealth Management

CFA Society of the UK

City of London Law Society

ConvergEx Group / Westminster Research Associates LLC

CorporateAccess.net

Credit Suisse Securities (Europe) Ltd

Euromoney Institutional Investor LLP

European Association of Independent Research Providers (EuroIRP)

Financial Services Consumer Panel

Gerson Lehrman Group

Henderson Global Investors

ICI Global

Ingage

International Capital Market Association - Asset Management and Investors Council (AMIC)

Investment Adviser Association

Investment Management Association (IMA)

Investor Relations Society (IR Society)

Investorside Research Association

Japaninvest Group

M&G Investment Management

Managed Funds Association

Manifest Information Services Ltd

Markit

Mercer

Morningstar

National Association of Pension Funds (NAPF)

New City Initiative

New Street Research LLP

Newton Investment Management Ltd

Numis Securities

Polunin Capital Partners Ltd

Redburn Partners LLP

SCM Private

Society of Pension Consultants (SPC)

Trusted Sources

UBS AG

Independent responses:

Alistair Haig, University of Edinburgh Business School

Bruce Packard

Appendix 1
Made rules (legal instrument)