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Financial Services and Markets

Dealing commission: the road towards unbundling – new rules

Following the FCA's consultation over the winter on amendments to the "use of dealing commission" provisions in COBS 11.6, it has now published its final rules. While there have been some amendments to the rules and guidance as originally proposed, the policy and the substance have not changed.

Feedback on the consultation and the final rules are set out in PS14/7, which was published on 8 May 2014 and is available here http://www.fca.org.uk/news/firms/ps14-07-changes-to-the-use-of-dealing-commission-rules. The new rules come into force in just under three weeks time on **2 June 2014**.

We noted some of the key points arising out of CP13/7 in our briefing note of 25 November 2013. Our observations, updated in the light of the final rules and the FCA's policy comments, are as follows:

A three-limb exemption and "reasonable grounds"

- In the consultation the FCA had proposed that the exemption from the general prohibition against using dealing commission would no longer be qualified by whether the investment manager had "*reasonable grounds to be satisfied*" that the relevant goods or services related to execution or amounted to research. Many respondents objected to this move towards a "strict liability" application of the rule. In recognition of these concerns – at least to an extent – the FCA has reformulated the exemption to make it clear that there are three limbs which must be satisfied, but only the first of these is subject to the reasonable grounds qualifier:

    - The investment manager must have *reasonable grounds* to be satisfied that the good or service will reasonably assist it in the provision of services to its customers;

    - The receipt of the good or service does not, and is not likely to, impair compliance with the duty to act in the best interests of customers; and

    - The good or service either is directly related to the execution of trades or amounts to the provision of substantive research.

  The last two limbs will not be subject to the "reasonable grounds" qualifier – the FCA believes that the assessment required to comply with both limbs is "essentially an objective consideration". The reformulated exemption is in COBS 11.6.3R(3).

- The FCA has added a new guidance provision in COBS 11.6.20G to the effect that investment managers should keep appropriate records of the basis upon which they make the assessment in reliance upon the above exemption. This was not in the consultation draft, but the FCA argues that the guidance simply makes explicit what has always been its expectation.

Substantive research and "meaningful conclusions"

- In order for something to amount to "substantive research" for the purposes of the exemption, it must present the investment manager with *meaningful conclusions* based on analysis or manipulation of data: in other words, the analysis and evaluation must be present in the research itself. This distinguishes permissible research from other more general information which should not be paid for with dealing commission. In its feedback,

> "*...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.*"
>
> **Financial Conduct Authority**
> **PS14/7 paragraph 2.8**

the FCA makes the point that the reference to "meaningful conclusions" under the criteria for research that can be acquired with dealing commission is not a new concept: it is a criterion that has been present since the rules were first made. In its policy response, the FCA says that a conclusion does not just have to be a conclusion to buy or sell: it "*can include a summary and statement of opinion, or making a reasoned deduction or inference, provided that the research contains this in itself*". It goes on to warn that reliance upon a "purely 'artificial' conclusion added by a broker or third party would not be in accordance with the spirit and intention of the rules".

- In CP13/7 the FCA had said that the exemption allowing the use of dealing commission for research does not extend to services that may be used by an investment manager in developing or preparing its own internal research or analysis. In the policy statement, the FCA clarifies that this means that a good or service that does not in itself meet the "substantive research" criteria in COBS 11.6.5E but which feeds into a manager's own internal research, does not *become* permissible research by virtue of its later application, e.g. where the manager applies its own conclusion. However, conversely, the FCA accepts that where third party research does meet the "substantive research" criteria but is only used mainly for the purposes of the manager's further internal research, it may be within the third limb of the exemption – but the firm will still need to satisfy the first limb of the exemption and show that it has *reasonable grounds* to be satisfied that the good or service will reasonably assist it in the provision of services to its customers.

- It stands to reason that if a manager receives a good or service which meets the "substantive research" criteria but which it will never use, the first limb of the exemption will not be satisfied, since it would not be able to show that it has reasonable grounds to be satisfied that it will assist it in the provision of services to customers.

- As consulted upon, the evidential presumptions in COBS 11.6.4E(2) and COBS 11.6.5E(2) will be qualified by two further evidential provisions in COBS 11.6.4E(3) and COBS 11.6.5E(2): so, whereas compliance with the specified criteria in COBS 11.6.4E(1) or COBS 11.5.5E(1) will still be taken as "tending to establish" compliance with the dealing commission rule, contravention of those criteria in future will be taken as "tending to establish" a breach of that rule. The addition of a presumption of contravention clause shifts the burden of proof and means that the evidential provisions are imbued with a rule-like status. In the policy statement, the FCA said that the new approach "*means that 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, it went on to say that "*we would not expect 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 end of the road for corporate access?

The FCA has stuck to its guns on a new, widely-drawn definition of "corporate access services" – a "service of arranging or bringing about contact between an investment manager and an issuer or potential issuer."

The FCA does not regard corporate access services as meeting the evidential requirements of either COBS 11.6.4E(1) (goods or services directly related to the execution of trades) or COBS 11.6.5E(1) (goods or services amounting to the provision of substantive research) and dealing commission must not be used to pay for it (COBS 11.6.8G(4A)).

While it is clear that the cost of corporate access by itself cannot be taken out of dealing commission, a number of responses to the consultation paper raised the fact that such access can often be provided in the context of a wider event or service which may include substantive research elements, such as investor industry conferences or investor field trips. For example, in addition to access to issuers, the investment manager may, during the same conference, receive some research from a broker's analyst or other industry expert that it asseses as substantive. Likewise, during an investor field trip, the arranging broker or other third party may provide a report or briefing which amounts to substantive research. In these cases, (assuming it wishes to pay for the cost of these components out of dealing commission) the investment manager must disaggregate the discrete element of eligible substantive research from the ineligible elements (such as corporate access) and is required to make a fair assessment of the charge that will be passed onto customers.

Responses also made the point that the FCA guidance on "mixed-use assessments" in the consultation draft was not as clear as it might have been, particularly given that component goods or services might not be individually priced. In recognition of this, the final draft guidance in COBS 11.6.8AG(1) contains new wording which provides that, if a manager intends to pass on a charge to a customer in reliance upon the exemption but the relevant good or service is not distinctly priced, the manager must make a "fair assessment" of the charge that it would be permitted to pass on; and, in doing so, it may need to consider whether it can carry on a "fact-based analysis" of the unpriced good or service. This may involve using other comparatively priced goods or services or an estimate of the cost of providing a comparable good or service internally.

On a connected theme, the FCA has also expanded upon its guidance in relation to the disaggregation a manager must carry out where it receives goods and services on a bundled basis, including elements which are substantive research and elements which are not. As we noted in our November briefing, investment managers may face problems in being able to disaggregate – or unbundle – these services and in being able to allocate a fair cost to the allowable components. The expanded guidance (in COBS 11.6.8AG(2)(b)) suggests that a manager might consider the amount it would be willing, in good faith, to pay for those non-chargeable elements and this may assist in determining the level of charges that can be passed on to the customer.

While the FCA's new guidance is intended to clarify, it remains to be seen how helpful managers will find it in practice. It is important that if a manager intends to apply a mixed-used assessment and/or to disaggregate components of bundled services or goods in line with the guidance, it carefully documents the basis upon which it does so – it will need to be able to show the FCA its "workings".

There are also practical issues with regards to "free" corporate access that some investment firms may receive – the FCA does not offer any specific guidance in COBS 11.6 in relation to this, but says in the policy statement that it expects firms to consider and comply with COBS 11.6 (use of dealing commission), COBS 2.3 (inducements) and SYSC 10 (conflicts of interest).

As we mentioned in our briefing note last November, the FCA is not (at this stage at least) banning the activity of arranging corporate access as such or managers paying for it out of their own pockets (subject to compliance with the market abuse rules). It is also not discounting the possibility of the manager allocating the costs of corporate access to its clients (subject to their consent and compliance with the firm's other duties under the rules (including in relation to managing conflicts of interest and acting in their clients' best interests)). Paying for corporate access out of dealing commission, however, is simply not justified in the FCA's view.

The journey continues

The new rules are not the end of the story. During the consultation process some respondents suggested that the changes did not go far enough and that wider reforms were required. The policy statement does not address these views, but the FCA will be considering them and reporting back later in the year. At the same time, it is also mindful of the fact that the revisions to the Markets in Financial Instruments Directive (MiFID) legislation are close to final adoption ("MiFID II") and, following the "Level 2" process the package is likely to be in force towards the end of 2016 or early 2017. The recast Directive will essentially ban investment managers from accepting or retaining any monetary or non-monetary benefits from third parties in relation to the provision of the service to clients – this is likely to have a significant impact upon COBS 11.6.

For further information on any of the issues discussed above, please contact any of the financial services partners named below.

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