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Financial Services and Markets

Dealing commission consultation: more controls on the road towards unbundling

Following its thematic work on conflicts of interest last year and as presaged at its recent Asset Management Conference, the FCA has published a consultation paper (CP13/17) setting out proposed amendments to the "use of dealing commission" rules in COBS 11.6.

The consultation, which is available here http://www.fca.org.uk/news/cp13-17-use-of-dealing-commission closes on **25 February 2014**. The proposals are required reading for investment managers who are subject to the dealing commission rules, but sell-side suppliers of bundled brokerage arrangements, who are within the ambit of the FCA's wider thematic review in this area, should also take note.

Underpinning COBS 11.6 and the "default" ban on goods and services being paid for with dealing commission is the premise that a manager should not use such commissions, which are paid by the client, to subsidise what are considered to be the core costs of the manager's business unless those costs qualify as "research" or "execution".

Some key points to note from the FCA's consultation and proposed rule amendments include the following:

- The question of whether an exemption from the general prohibition against using dealing commission is available will be further "objectivised"; it will 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;

- The evidential presumptions in COBS 11.6.4E(2) and COBS 11.6.5E(2) will be reversed: so, whereas compliance with the specified criteria in COBS 11.6.4E(1) or COBS 11.6.5E(1) will currently 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 FCA attempts to argue that this reversal to a presumption of breach is a "clarification".

- Corporate access services, as defined, will not, in the FCA's view, relate to the execution of trades or amount to the provision of substantive research.

- The FCA will further clarify that in order for something (whether corporate access or anything else) 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, the FCA maintains, will never be true of corporate access services by themselves (because the corporate access "arranging" service will not in itself provide any "new insights", or involve "analysis or manipulation of data to reach meaningful conclusions" (see COBS 11.6.5E)).

- Furthermore, any internal research or assessment of data carried out by the investment manager (whether following a corporate access visit or otherwise) can never be categorised as "research" for the purpose of the dealing commission rules; the costs of any such activities must not be deducted from dealing commission.

- While this may be cold comfort for many managers, the FCA stresses that it is not banning the activity of arranging of corporate access per se or managers paying for it (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 FCA proposes new guidance on disaggregation – so that where a manager receives goods and services on a bundled basis, which include elements which are substantive research and elements which are not, the manager shall only apply the exemption in relation to the justifiable elements. The problem for an investment manager – which may not be solvable without the cooperation of the sell-side - will be in being able to disaggregate – or unbundle – these services and to be able to allocate a fair cost to the allowable components.

The FCA signals the fact that, as part of its ongoing thematic work in relation to dealing commission, it will be conducting industry round-tables and follow-up visits with buy-side and sell-side firms in the near future (late 2013/early 2014). In the light of this and the fact that the policy statement and final rules on dealing commission will be published in Spring of next year, investment management firms in particular must refocus their attentions on their commission arrangements, particularly to the extent that corporate access or market data services are relevant.

Finally, the FCA's domestic dealing commission regime and the changes proposed in the short term must be seen against the wider backdrop of evolving European legislation. Recast versions of the Markets in Financial Instruments Directive (MiFID) legislation are currently being negotiated in trilogue at the European level and so further amendments to the dealing commission rules – and harmonised requirements in relation to unbundling generally – may be on the horizon.

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

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