

# Discussion on the use of dealing commission regime:

Feedback on our thematic supervisory review and policy debate on the market for research

July 2014





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We are asking for comments on this Discussion Paper by 10 October 2014.

You can send them to us using the form on our website at:  
[www.fca.org.uk/your-fca/documents/discussion-papers/dp14-03-response-form](http://www.fca.org.uk/your-fca/documents/discussion-papers/dp14-03-response-form)

**Or in writing to:**

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**Email:** [dp14-03@fca.org.uk](mailto:dp14-03@fca.org.uk)

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

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

You can download this Consultation Paper from our website: [www.fca.org.uk](http://www.fca.org.uk).

## Abbreviations used in this paper

|                        |                                                                                                                                                               |
|------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>AFME</b>            | Association for Financial Markets in Europe                                                                                                                   |
| <b>AIFMD</b>           | Alternative Investment Fund Managers Directive (2011/61/EU)                                                                                                   |
| <b>AIFMs</b>           | Alternative Investment Fund Managers                                                                                                                          |
| <b>COBS</b>            | Conduct of Business Sourcebook                                                                                                                                |
| <b>CP</b>              | Consultation Paper                                                                                                                                            |
| <b>CSA</b>             | Commission Sharing Arrangement                                                                                                                                |
| <b>DP</b>              | Discussion Paper                                                                                                                                              |
| <b>ESMA</b>            | European Securities and Markets Authority                                                                                                                     |
| <b>EU</b>              | European Union                                                                                                                                                |
| <b>FCA</b>             | Financial Conduct Authority                                                                                                                                   |
| <b>FSA</b>             | Financial Services Authority                                                                                                                                  |
| <b>IMA</b>             | Investment Management Association                                                                                                                             |
| <b>IOSCO</b>           | International Organisation of Securities Commissions                                                                                                          |
| <b>IPO</b>             | Initial public offering                                                                                                                                       |
| <b>MiFID</b>           | Markets in Financial Instruments Directive – consisting of Directive 2004/39/EC ('MiFID Level 1') and the Implementing Directive 2006/73/EC ('MiFID Level 2') |
| <b>MiFID II</b>        | The recast Markets in Financial Instruments Directive 2014/65/EU ('MiFID II Level 1') – there will also be a recast Directive 2006/73/EC ('MiFID II Level 2') |
| <b>PS</b>              | Policy Statement                                                                                                                                              |
| <b>UCITS Directive</b> | Undertakings for the Collective Investment in Transferable Securities Directive (2009/65/EC)                                                                  |



# 1.

## Overview

### Introduction

- 1.1** We have recently consulted on and made clarifications and enhancements to our use of dealing commission rules through CP13/17<sup>1</sup> and PS14/7.<sup>2</sup> These amendments, effective from 2 June 2014, delivered improvements to address our concerns over investment managers' controls and judgements in this area following our 2012 supervisory work.<sup>3</sup>
- 1.2** However, as we set out at our Asset Management Conference in October 2013, we have also carried out a wider review on whether further reform is needed to the regime in the medium term to deliver a more transparent and efficient asset management sector for the benefit of end investors.<sup>4</sup>
- 1.3** This Discussion Paper (DP) reports on our recent supervisory findings and a series of roundtable and bilateral discussions with stakeholders that have examined how the use of dealing commission, specifically for the purchase of research, currently functions.
- 1.4** We consider the effects our use of dealing commission regime has on the wider market for research, including competition implications, and the value for money achieved by investment managers for their underlying investors. We reflect on the key points made to us in our discussions with stakeholders on the need for and effects of change.
- 1.5** We also outline how both our existing regulatory framework and market practices in this area might be affected by future changes in the recast Markets for Financial Instruments Directive (MiFID II). We indicate our views on the latest development in the EU process and the direction of these reforms.
- 1.6** UK investment managers pay an estimated £3bn of dealing commissions per year to brokers, with around £1.5bn of this spent on research. These transaction costs are borne directly by investment managers' customers. We have had ongoing concerns about investment managers' controls over the use of dealing commissions and the conflicts of interest it creates for them as agents to their customers, given the lack of transparency of these costs. This is exacerbated by the largely unpriced and opaque market for research.
- 1.7** The purpose of our wider review was to explore the extent of the issues and whether more structural reform is needed to improve the efficiency and transparency both of investment

<sup>1</sup> CP13/17, *Consultation on the use of dealing commission rules* (November 2013). Source: [www.fca.org.uk/news/cp13-17-use-of-dealing-commission](http://www.fca.org.uk/news/cp13-17-use-of-dealing-commission)

<sup>2</sup> PS14/7, *Changes to the use of dealing commission rules: feedback to CP13/17 and final rules* (May 2014). Source: [www.fca.org.uk/news/firms/ps14-07-changes-to-the-use-of-dealing-commission-rules](http://www.fca.org.uk/news/firms/ps14-07-changes-to-the-use-of-dealing-commission-rules)

<sup>3</sup> 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](http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf)

<sup>4</sup> Martin Wheatley speech, 'Shaping the Future in Asset Management', FCA Asset Management Conference (October 2013). Source: [www.fca.org.uk/news/shaping-the-future-in-asset-management](http://www.fca.org.uk/news/shaping-the-future-in-asset-management)

managers and the market for research. Any reform would seek to ensure investment managers are managing costs appropriately in the best interests of their customers, and that competition in the market is effective, to ensure an optimal level and quality of research is supplied to the market at the best price.

- 1.8** Our review of the use of dealing commissions forms part of our broader focus and work on wholesale conduct issues, where poor practices and controls by investment firms, in their wholesale activities, can feed through to higher costs for end investors. This includes our thematic review looking at best execution, which we will report back on shortly. We have also recently published a call for input on our planned wholesale sector competition review, putting forward suggestions on a number of potential future market studies.

### Key messages

- 1.9** As we set out in detail below, the findings from our thematic supervisory review conducted from November 2013 until February 2014, covering both investment managers and brokers, supports the case for structural change. In summary, we found that:
- While some investment managers have improved their governance over how they purchase research with dealing commissions, there are still too few firms applying sufficient rigour in assessing the value of the research services they use.
  - There is a lack of price transparency in the market for research due to the way the market has evolved, and the bundled supply of execution and research services by brokers makes price discovery difficult.
- 1.10** We have also carefully considered the range of views conveyed to us in the wider roundtable discussions held with stakeholders over the same period, involving over 130 firms and trade bodies. The debate covered existing issues in the market, and the pros and cons of structural change, versus more incremental improvements combined with close regulatory oversight. We provide a detailed analysis of our policy views based on our supervisory findings and these discussions.
- 1.11** Overall, we conclude that unbundling research from dealing commissions would be the most effective option to address the continued impact of the conflicts of interest created for investment managers by the use of a transaction cost to fund external research. We believe it would drive more efficient price formation and competition in the supply of research, removing the current opacity in the market. It would be particularly effective if this reform can be achieved on an EU-wide basis.
- 1.12** EU reform under MiFID II represents a unique opportunity to deliver significant structural change on a pan-European basis. MiFID II Level 1 was agreed in January 2014, shortly after we started our review.<sup>5</sup> It has indicated a significant restriction on the goods and services an investment manager can receive from third parties linked to their services to clients, including dealing commission arrangements, allowing them to receive only 'minor non-monetary benefits'.<sup>6</sup> The final Level 1 text has confirmed our view that changes were likely under MiFID II, and that our debate launched in October would mainly help to inform discussions on the more detailed aspects of the reforms.

<sup>5</sup> Directive 2014/65/EU (MiFID II Level 1) was published in the Official Journal of the European Union on 12 June 2014. Source: [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2014.173.01.0349.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.173.01.0349.01.ENG)

<sup>6</sup> MiFID II Level 1, Article 24(8)

- 1.13** ESMA's Consultation Paper on their advice on proposals for MiFID II Level 2 measures that will support MiFID II Level 1 is an important next step in this debate. In this paper, ESMA states that: 'any research that involves a third party allocating valuable resources to a specific portfolio manager would not constitute a minor non-monetary benefit and could be judged to impair compliance with the portfolio manager's duty to act in their client's best interest.'<sup>7</sup>
- 1.14** In our view, this would effectively mean the 'unbundling' of research from dealing commission arrangements on an EU-wide basis, except for the most generic, widely available commentary. We support this proposed approach, and we believe it can bring lasting improvements in the transparency and efficiency of investment management to the benefit of consumers. This DP serves to further the evidence base and analysis on this topic during ESMA's consultation.
- 1.15** We discuss our policy view of the implications of unbundling research from dealing commissions, compared to more incremental changes. We support our preference for an unbundling option, based the direction of EU reforms, with a high level cost benefit and competition analysis on the impact on market participants and the market for research. This also considers the key concerns stakeholders have raised in discussions with us on the possible effects of unbundling research from dealing commissions.
- 1.16** These include the impact on the level of research coverage in the market, concerns over the liquidity of UK mid and small-cap company shares, and the competitiveness of UK investment managers in an international context. We conclude that the positive effects on the efficiency of both the investment management sector and the market for research – with resulting benefits for end investors – will, on balance, outweigh possible negative impacts.
- 1.17** We are not currently consulting on detailed policy proposals, given the interaction with potential EU reforms. However, this DP and the responses we receive will help inform whether and, if so, how we make further changes to our existing use of dealing commission regime as we consider the implementation of MiFID II, which will apply by early 2017. We welcome views on our analysis in this DP and want to maintain the open dialogue on the use of dealing commission and the market for research.
- 1.18** We are also continuing to engage with other international regulators on these issues through the International Organisation of Securities Commissions (IOSCO). We recognise that investment managers often operate on global lines, and that any EU-wide structural change would further benefit from a wider, international consensus.

### Who does this document affect?

- 1.19** This DP will interest:
- Investment managers, including UCITS management companies when carrying on scheme management activity and alternative investment fund managers (AIFMs) carrying out AIFM investment management functions respectively.
  - Customers of investment managers, including:
    - institutional investors, for example retail fund and pension fund trustees

<sup>7</sup> ESMA, *Consultation paper: MiFID II / MiFIR* (May 2014), page 121, paragraph 14. Source: [www.esma.europa.eu/content/Consultation-Paper-MiFID-II-MiFIR](http://www.esma.europa.eu/content/Consultation-Paper-MiFID-II-MiFIR)

- retail investors who have investments in retail funds (which may be through a wrapper such as an Individual Savings Account), or who have a direct relationship with an investment manager, for example individuals with discretionary-managed investment portfolios.
- Brokers (including investment banks), and third party providers of independent research and other ancillary services supplied to investment managers.
- Relevant trade associations and representative bodies for the above groups.

### **Will this be of interest to consumers?**

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- 1.20** This DP will be of direct interest to institutional investors, such as the trustees of pension funds, as well as individuals with discretionary-managed investment portfolios. 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.
- 1.21** This paper does not present immediate, detailed reform proposals, although it does discuss potential medium term changes to our use of dealing commission regime. Specifically, we discuss potential reforms that may occur under or alongside our implementation of MiFID II, which will apply in the UK by early 2017. This may be extended to cover investment management activities falling under AIFMD and the UCITS Directive (see below). We set out our view that existing EU reform proposals – to unbundle most research from dealing commission arrangements – could better align investment managers' incentives to control costs and act in the best interests of their customers, and bring improved efficiency and competition in the market for research.

### **An overview of the paper**

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- 1.22** The paper is split into sections as follows:
- Chapter 2 summarises the context for this work, and provides an update and analysis of the potential impact from EU reforms to MiFID and wider international discussions
  - Chapter 3 presents the findings from our thematic supervisory review
  - Chapter 4 reflects on our recent engagement and discussions with stakeholders on the current regime and need for further reform
  - Chapter 5 analyses options for future reform and the potential effects of structural changes on investment managers and their customers, as well as other market participants, and the impact on competition in the market for research

## Developments on MiFID II

- 1.23** As discussed in Chapter 2, the Level 1 proposals for MiFID II have now been finalised. The Level 1 text prevents portfolio managers<sup>8</sup> from receiving any third party inducements, with a limited exception for 'minor non-monetary benefits'.<sup>9</sup> We believe this indicates that an investment manager's ability to receive research from brokers or other third parties in return for dealing commissions will be significantly restricted.
- 1.24** ESMA has since published a consultation paper on 22 May 2014 on their proposed advice to the European Commission (the Commission) on the detailed rules for the MiFID II Implementing Directive (MiFID II Level 2). ESMA's consultation discusses the meaning of 'minor non-monetary benefits'.<sup>10</sup> They propose the Level 2 interpretation of this should be narrowly construed, so that only very generic, widely-distributed financial research can be considered a minor non-monetary benefit. By contrast, value-added research would not be a 'minor' benefit and could not be received by a portfolio manager as an inducement.
- 1.25** If this interpretation is adopted in the final MiFID II Level 2, we believe it would require the unbundling of most research from dealing commission arrangements for MiFID portfolio management activity. This would require a significant change to our rules in COBS 11.6. We also discuss the scope of MiFID II in the context of this potential change.

## Feeding back on the supervisory findings

- 1.26** We considered 30 firms in our recent thematic supervisory work (17 investment managers and 13 brokers), which took place between November 2013 and February 2014. We detail and feedback on the findings of these visits in Chapter 3. In summary, the findings from our supervisory work were:

- **Investment managers**

- Many of the firms that we visited had made improvements since November 2012, which should have resulted in better outcomes for their clients, but only two firms were operating at the level we would expect.
- 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.
- 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

<sup>8</sup> The definition of portfolio management under MiFID II is unchanged from the original MiFID, and so is the exemption for managers of collective investment undertakings. MiFID II will continue to not apply to portfolio management carried on by, for example, UCITS management companies or alternative investment fund managers acting in such capacities (see Articles 2(1)(i) and 4(1)(8) of MiFID II Level 1). But MiFID II continues to apply to such firms when they act as portfolio managers outside of those capacities, and also to third party portfolio managers providing services to UCITS management companies or AIFMs.

<sup>9</sup> Article 24(8) of MiFID II Level 1

<sup>10</sup> ESMA, *Consultation paper: MiFID II / MiFIR*, Section 2.15, pp.118-125

conducting a review of the issue, taking steps to strengthen its controls and is in active discussions with us to determine redress.

- **Brokers**

- Brokers did not explicitly price their research as a distinct service, leading to price opacity in the market. This contributes to investment managers' difficulties in ensuring they are paying an appropriate amount for research and execution.
- Brokers had not given adequate consideration to their potential conflicts of interest when arranging corporate access with some being unclear who they were acting for, corporate or investment manager. This was partly mitigated by the corporates being aware of the potential conflict.

### Stakeholder discussions and policy analysis

**1.27** Our open discussions with over 130 firms and trade bodies included seven roundtables and many bilateral meetings with both buy-side and sell-side firms (including independent research providers), from November last year into spring 2014. We also received wider comments as part of CP13/17 on medium-term reform options.

**1.28** In Chapter 4 of this DP, we reflect on these wide-ranging discussions with stakeholders on the need for further reforms to our dealing commission regime. We analyse the views and challenges received on the need for change, and how it should be achieved.

**1.29** We conclude from our discussions that:

- The use of dealing commission to fund external research will continue to give rise to conduct risks even with close regulatory scrutiny, due to the inherent conflict of interest it creates for investment managers by allowing research to be paid for with transaction costs borne by their customers' funds. This would otherwise be a cost of business for the firm.
- There have been some improvements since 2006, with more investment managers setting budgets, using CSAs, and engaging in tougher negotiations with brokers. However, these measures have not sufficiently improved the accountability and transparency over the use of dealing commissions. Research services paid for with commissions are still not valued with sufficient rigour. A link between levels of research payment and trading activity remains embedded in many firms' processes.
- Despite some of the arguments for retaining the ability to acquire research using dealing commissions, we view brokers' unpriced bundling of research and execution services as preventing transparent price formation and competition based on the quality of discrete research services. This makes it difficult for independent research providers to compete. It also adds to the challenge faced by investment managers when trying to assess the value for money of research.
- Investment banks prefer to bundle research services due to the complexity of their business models. A transparent, priced market for research appears highly unlikely to emerge organically without structural change.

### Options for change and a cost benefit and competition analysis

- 1.30** Following the conclusions from our supervisory work and discussions, we indicate our support for the opportunity offered by MiFID II to deliver reform across the EU that, based on our interpretation of ESMA's consultation proposals, would 'unbundle' most research from dealing commission arrangements.
- 1.31** We are aware that the unbundling of research from dealing commissions will represent a significant change for the market. While changes under MiFID II will be subject to an impact assessment by the Commission, in Chapter 5 we provide our initial views on some of the potential costs, benefits and competition effects we anticipate from this type of reform.
- 1.32** We believe unbundling would drive price transparency and a focus on value for money by investment managers, and more effective competition in the supply of research services. By detaching research payments from execution arrangements, investment managers would either bear the costs directly, find efficiencies in their research consumption, or reflect these costs in more visible headline charges (such as the annual management charge). This is likely to result in investment managers applying much more scrutiny to research spending, and seeking to maximise value for money to justify the value-added benefit obtained for their customers.
- 1.33** We also analyse views on the potential negative impacts on the market from unbundling research – such as UK firms' ability to compete internationally, concerns that research coverage may be reduced, and possible effects on the liquidity of UK mid and small-cap company shares. We feel these issues are likely to be less significant than some have suggested, especially if change is achieved under MiFID II.
- 1.34** Independent research providers would be able to compete much more effectively against brokers in a priced, unbundled market for research, and product and service offerings would become more diverse. Brokers would have to demonstrate the value added of their own research offering versus more specialist research providers, and would no longer receive research commissions simply due to trading activity.
- 1.35** We conclude, based on our high-level cost benefit analysis, that we expect significant benefits from unbundling research from dealing commissions, which would outweigh costs to industry or potential negative effects on the market.

### Next steps

#### What do you need to do next?

- 1.36** Firms should consider the findings of our supervisory thematic work set out in Chapter 3. They should take steps, where necessary, to ensure their existing practices and systems and controls are adequate to meet our current rules on the use of dealing commission.
- 1.37** We welcome responses to the questions set out in Chapter 5 of this paper, and summarised in Annex 1. Please send us your comments by **10 October 2014**.
- 1.38** Stakeholders should also consider whether they wish to respond to ESMA's Consultation Paper on MiFID II, details of which can be found on their website.<sup>11</sup>

<sup>11</sup> See: [www.esma.europa.eu/content/Consultation-Paper-MiFID-II-MiFIR](http://www.esma.europa.eu/content/Consultation-Paper-MiFID-II-MiFIR)

**How?**

- 1.39** Use the online response form on our website or write to us at the address on page 2.

**What will we do?**

- 1.40** We will carefully consider all comments received, and use these to inform our ongoing interactions in the EU process to reform MiFID II. We will also use responses to inform our considerations where there is any flexibility for the UK in how we implement further reforms linked to the use of dealing commissions, subject to compatibility with EU law.
- 1.41** We will aim to provide feedback on responses to this DP in late 2014 or early 2015. This will be timed to follow and provide an update on ESMA's final advice to the Commission on MiFID II Level 2.
- 1.42** It is likely that after the feedback to this DP, any further discussion or consultation on changes to our use of dealing commission regime will occur in the context of implementing MiFID II, as the final measures become clearer.

## 2. Background to our review and potential EU reforms

### Background to the current regime

- 2.1** The FSA introduced its rules on the use of dealing commission on 1 January 2006. They were designed to address conflicts of interests and misaligned incentives between investment managers and their customers. The rules were introduced following a review by the FSA between 2003 and 2005 of bundled brokerage and soft commission arrangements, which identified a number of market failures.
- 2.2** Before 2006, soft commission and bundled brokerage arrangements involved goods and services – such as investment research, seminars, external publications and data price feeds – being supplied to investment managers in return for business put through a broker. The brokerage charges were higher to offset the costs of services they supplied. In April 2003, the FSA published a consultation paper (CP176) together with a research study commissioned from Oxera, which identified significant concerns over bundling and soft commission arrangements.<sup>12</sup> These included:
- a lack of transparency and accountability over the costs of arrangements to customers, which could be leading to higher charges to consumers
  - the potential for unclear bundled arrangements to mask conflicts of interest where the investment manager may have an incentive to direct trades to certain brokers to maximise the goods and services they could obtain, which may not always be in the best interests of their customers
  - a lack of effective competition for services bundled with execution, such as third-party research
- 2.3** The FSA indicated that reforms were needed to provide stronger incentives for investment managers to make efficient decisions about trade execution and the purchase of ancillary services such as investment research, and to improve accountability to their customers. While the FSA initially proposed more radical reform that sought to unbundle services and costs (using a rebate method) for any non-execution related services, the responses to the consultation argued that alternative approaches could deliver similar improvements at less cost and impact to the industry.
- 2.4** The FSA was therefore persuaded to work with the grain of an industry-led solution and evolving market practices, which involved:

<sup>12</sup> CP176, *Bundled Brokerage and Soft Commission Arrangements* (April 2003). Oxera reports, *An assessment of soft commission arrangements and bundled brokerage services in the UK* and *Cost-benefit analysis of the FSA's policy propositions on soft commissions and bundling* (April 2003). Source: [www.fsa.gov.uk/pages/library/policy/cp/2003/176.shtml](http://www.fsa.gov.uk/pages/library/policy/cp/2003/176.shtml)

- new Handbook rules from 1 January 2006 limiting the range of goods and services that investment managers could acquire with dealing commission passed to their customers' funds to only 'execution' and 'research' goods and services (now COBS 11.6)
- enhanced disclosures by investment managers to their customers on the costs of execution and research paid for on their behalf through dealing commissions, based on industry-led codes of practice
- encouraging investment managers to seek, and brokers to provide, clear payment and pricing mechanisms that enable execution and research services to be purchased and valued separately – such as by using CSAs

**2.5** The FSA therefore adopted a principles-based approach, allowing investment managers to make reasonable judgements about what could constitute execution-related and research goods and services, which could then be purchased using dealing commissions. It expected enhanced disclosure by investment managers to improve accountability and encourage greater scrutiny of costs by their customers, acting as a critical check and balance. At the same time, market practices were expected to evolve naturally towards pricing and valuation of research due to use of CSAs and the splitting of commission rates. The FSA made it clear at the time that these rules would be subject to review if the desired outcomes did not materialise.

#### **Interaction of the 2006 rules with MiFID**

**2.6** When the UK implemented the Markets in Financial Instruments Directive (MiFID) in November 2007, the FSA retained the rules on use of dealing commission as an enhancement that built on the general inducements requirements under Article 26 of MiFID Level 2 (implemented in COBS 2.3).<sup>13</sup> The UK notified the Commission of this approach under Article 4 of MiFID Level 2.<sup>14</sup>

**2.7** We decided to extend our use of dealing commission requirements when we implemented UCITS, and later the Alternative Investment Fund Managers' Directive (AIFMD), which replicates the inducements rule under MiFID Level 2 in Article 24 of the AIFMD Commission Delegated Regulation.<sup>15</sup> Our use of dealing commission rules in COBS 11.6 are therefore also applied to firms now subject to the AIFMD.<sup>16</sup>

#### **Assessing the effectiveness of the 2006 rules**

##### ***Initial post-implementation review***

**2.8** To determine the impact of the new regime, the FSA commissioned Oxera to undertake a post-implementation review of the regime in 2008. The FSA also carried out a supervisory thematic review to assess compliance with the rules and progress under the industry-led solution towards the desired outcomes expected from the 2006 changes.<sup>17</sup> The FSA report in 2008 explored the following areas:

<sup>13</sup> MiFID Implementing Directive (2006/73/EC), Article 26.

<sup>14</sup> MiFID Implementing Directive (2006/73/EC), Article 4. The UK notification is available on the Commission's website here: [http://ec.europa.eu/internal\\_market/securities/isd/mifid\\_implementation/index\\_en.htm](http://ec.europa.eu/internal_market/securities/isd/mifid_implementation/index_en.htm)

<sup>15</sup> Directive 2011/61/EU and the Commission Delegated Regulation 231/2013

<sup>16</sup> As set out in CP13/9 and PS13/5, *Implementation of the Alternative Investment Fund Managers Directive* (June 2013). Source: <http://www.fca.org.uk/your-fca/documents/ps13-5-implementation-of-the-aifmd>

<sup>17</sup> FSA Report, *Use of dealing commission – results of thematic review* (January 2008). Source: [http://www.fsa.gov.uk/pubs/other/Dealing\\_Commission.pdf](http://www.fsa.gov.uk/pubs/other/Dealing_Commission.pdf)

- Whether investment managers were securing value for money for their clients in respect of execution and research spend including the agreement of a split of commission rates into execution and research components.
- The adoption and operation of commission sharing arrangements.
- The goods and services purchased using commission and the process for ensuring that these met the new criteria for execution and research.
- The disclosure of the goods and services acquired with commission and the feedback received from clients on the disclosures received.<sup>18</sup>

**2.9** Both reports indicated that the market had made some initial improvements and showed signs of moving towards delivering the intended outcomes. Investment managers had started to engage with brokers regarding the split of commission into research and execution elements, and some were reviewing value for money received.

**2.10** However, there was less progress in other areas. Disclosure to customers, in particular, was proving ineffective in enhancing the accountability of investment managers. It was found that most pension fund trustees, for example, did not review the information on dealing commission arrangements, nor use it to challenge their investment manager.<sup>19</sup> The FSA also noted ‘instances where investment managers appear to be seeking to maintain as far as possible their existing practices.’<sup>20</sup> In addition, there were issues around the use of CSAs; for example, the speed with which independent providers were paid.

#### ***Conflicts of interest review in 2012***

**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.

**2.12** Two investment managers did display good practices. One firm was making a proper assessment of the research services they valued from brokers and challenging the broker on why they should pay for others. Another was using budgets and switching to execution-only rates to allow them to carefully manage their commission payments.

**2.13** However, we also found a number of investment managers who had no central organisation of commission payments, and paid for research services by directing business to particular brokers on a trade-by-trade basis. It was unclear to us how firms using this approach monitored whether they were acting in their customers’ best interests. 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.

<sup>18</sup> FSA, *Use of dealing commission – results of thematic review*, para 3.1

<sup>19</sup> Oxera, *The impact of the new regime for use of dealing commission: post-implementation review*. Source: [www.fsa.gov.uk/pubs/other/oxera\\_dealing\\_commission.pdf](http://www.fsa.gov.uk/pubs/other/oxera_dealing_commission.pdf)

<sup>20</sup> FSA, *Use of dealing commission – results of thematic review*, para 4.

<sup>21</sup> FSA, *Conflicts of interest between asset managers and their customers*

<sup>22</sup> FSA, *Conflicts of interest between asset managers and their customers*, paragraph 3.3, page 8

- 2.14** Alongside the report, we issued a Dear CEO letter to all investment managers. It asked their boards to review their conflicts of interest management in light of the findings in our report. Each firms' CEO had to attest to us that they were satisfied that their firm managed conflicts effectively and in compliance with our rules by 28 February 2013.

### Our current review

- 2.15** Based on our 2012 supervisory work, we believed further consideration of the use of dealing commission regime was needed. Some of the issues we detected were due to varying interpretations and judgments being made by investment managers compared with the original intention of the rules in 2006. But there was also evidence suggesting wider, inherent flaws in the regime, which may require more fundamental change in the medium term to ensure good outcomes for end investors. Progress by firms and evolution in market practices – especially towards assessing the value of research and transparent pricing – was limited given our rules have been in place for some time.

- 2.16** Therefore, we announced at our Asset Management Conference in 2013 our intention to consult on immediate clarifications to the existing rules, alongside launching an open discussion on the need for wider, more forward-looking reforms to the use of dealing commission regime:

*[T]he FSA committed to keep the regime under review if it failed to address shortcomings it was designed to tackle. We have now reached a point, evidenced by our supervisory work where we need to think again. The system is not working as intended. Wider reform is now required to address these flaws that cannot simply be addressed by incremental improvements to the existing rules.<sup>23</sup>*

- 2.17** We also initiated the review due to two other factors:

- EU negotiations on legislative reforms to the MiFID Level 1 text were in the advanced stages at that time. Since MiFID II is a key vehicle in seeking European-wide reform to rules linked to investment managers' ability to receive goods and services in return for dealing commissions, a discussion in the UK would help inform and influence this debate, especially on the more detailed Level 2 requirements.
- Debate that was already occurring in the industry indicating a consensus that further improvements were needed to the current regime. In particular, the Investment Management Association (IMA) review into the market for research, which began in July 2013, with their report subsequently published in February 2014.<sup>24</sup> We were keen to harness this proactive engagement and debate.

### The clarifications and enhancements to our rules

- 2.18** We have subsequently published CP13/17 and PS14/7. These publications and the changes made in COBS 11.6 are intended to improve investment managers' assessments of what is eligible research that can be purchased with dealing commissions under the current rules. We clarified and enhanced the evidential criteria for substantive research, and introduced new guidance on corporate access and making mixed-use assessments where investment managers receive bundled services.

<sup>23</sup> Martin Wheatley speech, 'Shaping the Future in Asset Management' (October 2013).

<sup>24</sup> IMA, *The use of dealing commission for the purchase of investment research* (February, 2014). Source: [www.investmentfunds.org.uk/assets/files/research/2014/20140218-imadealingcommissionresearch.pdf](http://www.investmentfunds.org.uk/assets/files/research/2014/20140218-imadealingcommissionresearch.pdf)

- 2.19** The changes are intended to drive improvements by firms and enhance our ability to supervise these rules over the next few years in response to our findings in 2012. They also reflected the desire to remain consistent with our approach under the current MiFID – given EU discussions were well under way to revise this legislation. We wanted to consider and align any further (and potentially more fundamental) change with the implementation timing of MiFID II.

#### **The wider review and reform debate**

- 2.20** Since November 2013, we have conducted a thematic supervisory review and a series of roundtable discussions with stakeholders to consider whether more fundamental reform to the current dealing commission regime could better align incentives on investment managers to act in the best interests of their customers.
- 2.21** We examined and discussed market practices between investment managers on the buy-side and brokers on the sell-side, as well as other research providers, to consider how the market for research could work more effectively to promote better market integrity and competition in the interest of consumers. We feedback on the supervisory findings in Chapter 3, and our roundtable discussions in Chapter 4.
- 2.22** We were clear when we launched this review that no options were ruled out, but our preferred option was for any fundamental reform to be achieved through MiFID II. We noted that the unbundling of research from dealing commission arrangements was one possible outcome, based on the position of the Level 1 negotiations at that time. Our review was designed to inform EU discussions on MiFID II, especially the more detailed Level 2 measures that were likely to be needed to support the final Level 1 agreement.
- 2.23** We therefore discuss the latest developments on MiFID II and the direction of travel for potential EU-wide changes immediately below, given its importance in shaping our discussion on the need for further reform and policy options (which we base on our interpretation of current MiFID II proposals) in Chapters 4 and 5. We also provide an overview of the wider international debate at the end of this chapter.

#### **EU progress on MiFID II**

- 2.24** EU negotiations and discussions to revise MiFID are now well advanced. MiFID II Level 1 was agreed between the European Parliament and European Council in January 2014, and was published in June.<sup>25</sup> In MiFID II Level 1, the treatment of inducements, which was formerly in the Level 2 Directive, has now been enhanced with more specific requirements in the Level 1 text.
- 2.25** Article 24(8) of MiFID II Level 1 prevents portfolio managers from accepting and retaining fees, commissions or any monetary or non-monetary benefits. There is a limited exception to this ban, but only for ‘minor non-monetary benefits.’ Article 24(8) of MiFID II states that: ‘Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm’s duty to act in the best interest of the client shall be clearly disclosed and are excluded from this paragraph.’<sup>26</sup>
- 2.26** This appears to have clear implications for our current UK rules in COBS 11.6, which allow investment managers to receive non-monetary benefits in the form of execution-related or

<sup>25</sup> Official Journal of the European Union, 12 June 2014.

<sup>26</sup> Article 24(8) of MiFID II Level 1

substantive research goods and services in return for dealing commissions paid to brokers for the execution of its customer orders, where those charges are passed on to the customer.<sup>27</sup>

- 2.27** However, as we stated during our domestic discussions, the nature and extent of this restriction will depend on the MiFID II Level 2 Implementing Directive that will underpin the Level 1 requirements. We anticipated this would set out in more detail how 'minor non-monetary benefits' relating to the inducements restriction on portfolio managers would be interpreted.
- 2.28** ESMA has now published its consultation on proposals for advice and draft measures for MiFID II Level 2, which it will provide to the Commission by the end of this year.<sup>28</sup> The Commission will then draft the final legislation in 2015.
- 2.29** ESMA's advice includes specific proposals on what will be permitted as 'minor non-monetary benefits' for firms providing portfolio management or investment advice, and a specific discussion on the treatment of research as a third party inducement. The exception is designed to be very narrowly construed, following the intention of the Level 1 in otherwise banning all inducements for portfolio managers.
- 2.30** ESMA's consultation states that under the new inducements rules for portfolio managers, only widely-disseminated, generic research will qualify as a minor non-monetary benefit acceptable under inducements arrangements. It will need to be considered on the basis that: 'all such benefits should only qualify as minor where they are reasonable and proportionate and of such a scale that they are unlikely to influence the recipients behaviour in any way that is detrimental to the interests of the relevant client.'
- 2.31** ESMA's commentary further proposes that, 'any research that involves a third party allocating valuable resources to a specific portfolio manager would not constitute a minor non-monetary benefit and could be judged to impair compliance with the portfolio manager's duty to act in their client's best interest.'<sup>29</sup>
- 2.32** Research that is bespoke in its content, or rationed in how it is distributed or accessed, or has material value, would not be a minor non-monetary benefit and so would not be permitted to be paid for through dealing commissions. ESMA views that, 'this would include privileged access to research analysts (e.g. face-to-face meetings or conference calls), bespoke reports or analytical models, investor field trips, or services linked to research such as corporate access and market data services, which by their nature are limited in access and/or can have a material value.'<sup>30</sup>
- 2.33** The effect of this new stance, in our view, would be to effectively 'unbundle' the receipt of all research from execution arrangements except for the most generic and widely disseminated financial research, which by its nature has little value.
- 2.34** ESMA states that investment managers would still be able to purchase more valuable research goods and services that fall outside the definition of minor non-monetary benefit, but would need to have separate contractual agreements with brokers or independent research providers for the supply of research. The portfolio manager would then have to make a commercial decision on how it paid for these services, which may include absorbing the cost themselves, or passing the costs through to their investors – for example in their annual management charge.

<sup>27</sup> See COBS 11.6.3R

<sup>28</sup> ESMA, *Consultation Paper on MiFID II / MiFIR*

<sup>29</sup> ESMA, *Consultation Paper on MiFID II / MiFIR*, Section 2.15, page 121, paragraph 14.

<sup>30</sup> ESMA, *Consultation Paper on MiFID II / MiFIR*, Section 2.15, page 121, paragraph 14.

- 2.35** As we discuss further below, we support this proposed change to the inducements requirements under MiFID II, and the consequential impact on our use of dealing commission rules. We believe the unbundling of research from execution arrangements across the EU would address many of our concerns with the existing UK regime.

#### **Wider scope of MiFID II inducements rules for portfolio managers**

- 2.36** Changes to the inducements rules for portfolio managers in MiFID II would apply across all MiFID financial instruments. Portfolio managers would not be able to receive valuable research related to executing orders in other instruments, such as money market instruments or corporate bonds. Some of these instruments do not involve explicit execution commissions, but a margin is priced into the 'bid-offer' spread presented by executing counterparties.
- 2.37** Some stakeholders have suggested to us in discussing our current use of dealing commission rules that research provided by brokers to investment managers linked to fixed income business poses similar problems to the use of dealing commissions in equities – such as a lack of transparency and conflicts of interests in where order flow is directed. It has been suggested that research can be effectively priced into the 'spread' on such transactions. While we have not explored this issue in our current work, MiFID II would effectively prevent such practices if indeed they do occur.
- 2.38** At present, changes under MiFID II requirements on portfolio managers would not apply to UCITS and AIFMD investment management activity without wider changes. ESMA's consultation paper recommends that the Commission explores harmonising the final MiFID II changes across these other directives to align inducements standards for all areas of investment management activity.<sup>31</sup>
- 2.39** We would strongly support a uniform application of any changes to the inducements rules – that in turn affect use of dealing commission arrangements – across MiFID, UCITS and AIFMD investment management activities. We believe the benefits to consumers of the reforms indicated by MiFID II on inducements are equally applicable in these other areas, especially for UCITS funds, which attract significant levels of retail investment. If MiFID II changes to the inducement requirements for portfolio managers are not replicated for UCITS and AIFMD at EU-level, we would need to carefully consider our implementation approach in the UK.

#### **International debate**

- 2.40** We are also aware of the global nature of asset management and the supply of execution and research goods and services. In part, this has informed our preference for wider reforms to be considered across the EU, as this provides the most immediate market in which UK investment managers must compete and the bases of our rules in this area (we discuss the competition aspects of any changes in Chapter 5, including in an international context).
- 2.41** However, as far as possible, a consideration of these issues on an international level is desirable. Many stakeholders, including the IMA in their report in February 2014, have emphasised the importance of including the US and Asia, in particular, when discussing potential reforms across the EU or in the UK affecting investment managers.

<sup>31</sup> ESMA, *Consultation Paper on MiFID II / MiFIR*, Section 2.15, page 122, paragraph 16.

- 2.42** For this reason, we have continued to engage with international regulators through IOSCO. This has included sharing some of our supervisory and policy work on the use of dealing commissions (or 'soft commissions' as they are referred to in some jurisdictions).
- 2.43** We believe global interest will increase if EU-wide reforms in this area appear more likely under MiFID II. If these reforms, as we anticipate, bring benefits to end investors by reducing conflicts of interest for investment managers, making them more efficient and transparent, and improving competition in the market for research, it seems likely this will influence the wider international debate. Globally active investment managers – who will wish to meet the highest standards in the best interests of their customers – may voluntarily move to adopt a similar approach. This would then be likely to have a knock on effect for international suppliers of execution and research services.

## 3. Supervisory findings

### Background

- 3.1** This chapter describes some of the practices we found in our thematic review, highlighting some of the inherent flaws in the current regime and providing ways that firms could improve how research is bought under the existing rules.
- 3.2** We considered how investment management practices have changed since we issued a Dear CEO letter in November 2012, which highlighted our concerns about how firms managed their use of dealing commissions to pay for research. It also considered the role of brokers when providing research services, including bundled arrangements for the provision of both research and execution services in return for dealing commissions.
- 3.3** There are two main messages from our work:
- While some investment managers have improved their governance over how they purchase research with dealing commissions, there are still too few firms applying sufficient rigour in assessing the value of the research services they use. We found two firms that had made significant enhancements and these will have resulted in better outcomes for their clients.
  - There is a lack of price transparency in the market for research due to the way the market has evolved, and the bundled supply of execution and research services by brokers makes price discovery difficult. We would like to see investment managers and brokers discuss more about the price of research services to allow investment managers to meet their obligations to their customers.

### What we did

- 3.4** We reviewed 30 firms as part of this thematic supervisory work. This involved 17 investment managers and 13 brokers. We also spoke to a number of independent research firms and corporate issuers.
- 3.5** Our assessment focused on:
- how firms pay for research out of dealing commission
  - the eligibility of research services investment managers are purchasing with dealing commission
  - how research is priced by brokers
  - conflicts of interest when arranging corporate access
  - how independent research providers price their goods and services

## Our findings

### Summary

#### 3.6 In overview our findings were:

- **Investment managers**

- Many of the firms that we visited had made improvements since November 2012, which should have resulted in better outcomes for their clients, but only two firms were operating at the level we would expect and there are still too few firms assessing the value of research with sufficient rigour.
- 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.
- One 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.

- **Brokers**

- Brokers did not explicitly price their research as a distinct service, leading to price opacity in the market. This contributes to investment managers' difficulties in ensuring they are paying an appropriate amount for research and execution.
- Brokers had not given adequate consideration to their potential conflicts of interest when arranging corporate access with some being unclear who they were acting for, corporate or investment manager. This was partly mitigated by some of the corporates being aware of the potential conflict.

### Investment managers

#### *How dealing commission is generated*

- 3.7 Dealing commission is paid to a broker every time an investment manager buys or sells shares in a company, with the costs borne by their clients. Investment managers are allowed under our rules in COBS 11.6 to use dealing commission to also acquire execution-related goods and services, and research that informs their investment or trading decisions.<sup>32</sup>

#### *How firms pay for research*

- 3.8 Investment managers pay for research out of dealing commission in one of two ways. They can pay a bundled rate including execution and research, which will be paid entirely to the executing broker, or they can choose to separate out the research element of dealing commissions by using a CSA. In practice firms typically use a mixture of bundled and CSA execution arrangements depending on the broker they are trading with and their own internal processes. In both instances, the split between execution and research will be determined by the investment manager.
- 3.9 A CSA is an agreement between the investment manager and the broker, which allows part of the execution commission to be separated and set aside to pay for research. At the point of execution the broker receives the execution component of the commission but the research

<sup>32</sup> See COBS 11.6 for the detail of our rules: <http://fshandbook.info/FS/html/handbook/COBS/11/6>

component goes into a separate account, held by the broker on behalf of the investment manager.<sup>33</sup>

- 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.
- 3.11** The broker that holds the accumulated balance will administer the payments from the pool at the instruction of the investment manager. This might mean paying other brokers or independent research providers, or retaining it themselves.
- 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.
- 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.

#### ***Our findings on how firms purchased research***

- 3.14** We found that the amount of dealing commission spent on research remained linked to the volume of trades carried out in a majority of the firms we visited. While it is reasonable that the amount paid for execution will fluctuate with the number and size of trades executed, the amount paid for research should not. It should instead represent the perceived value of the research used by the investment manager.
- 3.15** If payment for research and execution is truly separated, firms should 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.
- 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.

<sup>33</sup> For more detail, the IMA's report on 'The Use of dealing commission for the purchase of investment research' provides a useful overview of these payment mechanisms on pp.7-9

### **An example of a firm using budgets and CSAs to control research spend**

One firm had set research budgets with each individual broker as well as a total research budget. The firm would switch to execution only rates when the total budget had been met and then use CSA payments to ensure the individual brokers were paid the right amount.

This ensures that decisions about who to execute with are made separately from whom to pay for research and provides transparency to the broker as to what they are being paid for research. It helps the investment manager ensure that they have paid an appropriate amount for execution and research.

### **An example of the use of bundled rates without assessing the value of research**

One firm used a bundled approach, aiming to get the best outcome for their clients by achieving best execution when all factors such as price, cost and impact were taken into account. This firm had negotiated bundled rates much lower than anyone else in our sample. But without an assessment of the value of the research they were using, it was impossible for the firm to be certain it was paying an appropriate amount for research.

In this case, the commissions paid for research were only arrived at by applying a notional split to the bundled rates they had paid. This raised the question about what consideration, if any, was made of the value of research services they received from brokers.

- 3.17** Some of the better examples of investment managers seeking to assess the value of research involved an independent assessment by people not involved in the investment process, or the use of proxies such as other priced services in the market. This generally also involved the use of CSAs to ensure the correct payments could then be made. But only a few firms were adopting this kind of approach.
- 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. This voting then translates into a ranking, with brokers higher up in the ranking being rewarded with more full service, bundled trades or a greater percentage of the CSA balance at the end of the period.
- 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.
- 3.20** Some firms have a pro rata 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.

#### **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.

#### **An example of a larger firm's broker vote process embedding a link to trade volume in their spending on research**

One firm linked the number of 'broker votes' for research that each of their fund desks received to the levels of trading activity that desk had undertaken in a preceding period. This means that research spend fluctuates with the volume of trading undertaken and not the amount of research used.

#### **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.

### ***Eligibility of services***

- 3.21** Investment managers are only allowed to use dealing commission to acquire execution-related or research goods and services that meet the criteria set out in COBS 11.6.<sup>34</sup> As with our 2012 review, we found an investment management firm that was paying for services out of dealing commission that they were unable to demonstrate met the criteria for research. This 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 with dealing commission and which weren't.
- 3.22** Brokers that administer CSAs and make payments from those CSAs on behalf of investment managers were typically checking the eligibility of the services before making payments. We found examples of brokers challenging investment managers about what they were paying for through dealing commissions where a service did not appear to be eligible research.

<sup>34</sup> <http://fshandbook.info/FS/html/handbook/COBS/11/6>

- 3.23** We were encouraged that some brokers were taking this additional step, even though the regulatory responsibility remains with the investment manager. However, there were no examples of brokers refusing to make payments.

#### **An example of broker monitoring payments from CSAs**

One broker checked each payment instructed by an investment manager from the CSA balance against a list of pre-approved research providers. Where there was a payment to a new research provider, the broker would check if that provider appeared to be legitimate and capable of offering eligible research goods and services. If there was any ambiguity, the broker would ask the compliance officer at the investment manager to confirm in writing that the payment was being made in exchange for eligible research.

We saw this as a good check, as it prevents fraudulent or accidental payments to fictitious or inappropriate organisations as well as reminding the investment management firm that it is their responsibility to ensure the eligibility of services.<sup>35</sup>

#### ***Transparency to investment managers' clients***

- 3.24** While the total amounts paid for research are disclosed<sup>36</sup>, investment managers told us that they are rarely challenged by clients or trustees and depositories on these figures, leading us to question the effectiveness of these disclosures.

#### **Integrated brokers**

##### ***How is research priced?***

- 3.25** We found a range of broker models for assigning costs and assessing the profitability of their research offerings. It was clear that some brokers had been considering their approach in response to investment managers requesting more detail over the cost and price of their research. However, most brokers appeared to be unwilling or unable to provide this, which hindered the price formation process. We encourage brokers and investment managers to enter into discussions about how much different levels of service should cost.
- 3.26** Instead of providing a menu of services, most brokers targeted 'client profitability', seeking to maximise the amount of commissions received from investment managers in return for the research services provided. In most situations brokers set a minimum amount of commission that would have to be paid before they would give access to their written research portal.
- 3.27** Many brokers did not know the cost of the research services provided to clients and therefore found pricing difficult. A key reason for this is the complexity of brokers' businesses, whereby their research business is also integral to other services, such as corporate broking activities, derivatives and fixed income, and their own trading.
- 3.28** We found that research is both an internal resource for the investment bank, as well as a 'product' provided directly to their clients. The brokers varied as to whether they allocated research costs internally; when this did occur internal apportionment differed between firms. There was only one broker that treated their research as a completely standalone product, including from execution services, and so only received research dealing commission payments for that discrete service.

<sup>35</sup> We have not considered here any potential competition concerns from brokers being able to 'vet' and potentially delay payments to competing research providers (see Chapters 4 and 5).

<sup>36</sup> In line with the IMA Level 1 and 2 disclosure codes.

- 3.29** Brokers stated that when they were paid bundled commission rates they often did not know what element of the commission payment was for research, rather than execution, due to the payment being made in one lump sum. They also stated that the value of their research depended on how investment managers used it, yet investment managers did not provide detailed feedback on what they valued, so the brokers could not set a price. The brokers' position was that they wanted payment to reflect the cost of the overall continuous service, and were therefore reluctant to price services individually.

**An example of the opacity of dealing commission payments hampering brokers' pricing of research**

One broker told us that unless commission was paid via a CSA they had no knowledge of whether they were being paid for research or execution, since as most of the payments this firm received were bundled they were unable to determine whether research was profitable or what services clients valued most.

This could mean the broker was allocating resources to unwanted research in large companies instead of a growing sector where demand for research was high, possibly resulting in investment managers missing opportunities for their clients and smaller companies not receiving research coverage.

- 3.30** Brokers tend to use a client tiering system to allocate their research resources (e.g. allocation of senior analysts' time, production of bespoke research) and to prioritise their investment management clients (e.g. who gets the first call from an analyst after a significant announcement or event).
- 3.31** These tiers are typically set on a global basis across multiple business lines. This means that an important global client who pays a modest amount of dealing commission in Europe, but generates revenue for the broker in other business lines and/or in other regions, may still be ranked as a top-tier client and receive the same high level services as a firm that pays significant dealing commission to the broker in Europe due to the cross subsidised integrated broker business model.

**An example of cross-subsidies impacting price formation**

Due to the historical bundled nature of services and payments via dealing commission one broker had difficulties in attributing costs and assigning revenues to equity research. It was also a service that other internal departments relied on and the business was expected to operate. This meant that the firm had given little consideration to how they would price their research offering, which hindered the price formation process, as the firm had never treated research as a revenue generating activity on a standalone basis.

- 3.32** Historical practices and integrated brokers' complex allocation of research go some way to explaining why the market is the way it is today. But this could change if brokers and investment managers focus more on determining the value of research and setting a price.

***Conflicts of interest when arranging corporate access***

- 3.33** We found that brokers experienced difficulties in identifying who they were acting for – investment manager or corporate issuer client – when arranging corporate access services.<sup>37</sup> If they are acting for the corporate issuer they should ensure only those investors it is in the corporate's interest to see are given access. If, however, the broker is acting for the investment manager they should arrange corporate access to best meet the interests of the investment manager. Brokers should be transparent about who they are acting for and disclose what their role is.

***Corporates and independent research providers***

- 3.34** We also spoke to the corporates themselves to gain their perspective as clients of the brokers who provide corporate access and wider corporate broking services to them.
- 3.35** The corporates explained that the process of selecting investors to see in one-on-one or group meetings at investor 'roadshow' events was an iterative discussion they had with their broker. While it was clear the corporate would approve the final list and specify the majority of the investors they met, the broker also had input and would suggest investors.
- 3.36** Finally, to understand the market as a whole we also spoke to several independent research providers.
- 3.37** Independent research providers typically charge a fixed subscription fee for access to their ongoing research and charge a set fee for bespoke research. Others have a wider 'menu' of pricing options.
- 3.38** Some of the larger independent research houses have evolved to add a trading desk to offer agency execution. The firms in question stated that this increased their ability to attract research payments (e.g. it allowed payment with bundled commissions on executions by investment managers who don't operate CSAs), and such payments were also quicker than payments received from CSAs.
- 3.39** This does, however, also reflect our findings that where investment managers rely on bundled commission rates, they have less flexibility to pay providers specifically for research distinct from execution. If CSAs were being used more widely, or investment managers were prepared to pay for research other than through dealing commission arrangements, this would be unnecessary.

<sup>37</sup> Our changes to COBS 11.6 that took effect on 2 June 2014 have clarified corporate access services cannot be paid for with dealing commissions, and we also defined corporate access service in the FCA Handbook Glossary (see: <http://www.fshandbook.info/FS/html/FCA/Glossary/C>).

## 4.

# Policy debate

### Introduction

- 4.1** Alongside our supervisory thematic work to review the current regime, we initiated an open debate with stakeholders on the need for further reforms to the regime, and to discuss some of the key benefits and challenges of any changes. We held seven roundtables, met with individual firms, attended sessions with the IMA and the Association for Financial Markets in Europe (AFME), and also invited comments on wider reforms as part of CP13/17.
- 4.2** In this chapter, we reflect on the discussions and views received, and present our policy views based on these discussions, our supervisory findings and the direction of EU reforms under MIFID II.
- 4.3** In our discussions with stakeholders on the use of dealing commission regime and the market for research, we focused on the following main issues:
- investment managers' controls and oversight of their use of dealing commissions, assessing the value of research, and ensuring costs are managed effectively
  - transparency of costs and disclosures to customers
  - price transparency and effective competition in the supply of research
  - conflicts of interest and incentives in the current market
- A summary of discussions and our analysis**
- 4.4** Although there have been some improvements and more attention given to these issues since our review in 2012, our discussions suggest that robust controls remain limited to a handful of investment managers. Many valuation processes and controls over spending through dealing commissions – such as setting budgets and use of CSAs – still have weaknesses, despite investment managers recognising the importance of managing the costs of dealing commissions as akin to client money.
- 4.5** There remains an inherent conflict for the investment manager that by 'outsourcing' external research, paying for it through a transaction charge borne by their customers' funds, the firm reduces a cost that would otherwise need to be met with their own resources. This feature, in our view, continues to be the primary reason why most investment managers do not apply the same rigour in controlling these costs and valuing research as they would if they were spending the firm's own money. While some view better disclosure as a solution, we doubt the effectiveness of this approach.

- 4.6** Bundling also maintains perceptions among investment managers that “it creates the potential for full-service suppliers [investment banks] to discriminate against investment managers in areas unrelated to the provision of research, based on the level of commission spend.”<sup>38</sup> This may further distort investment managers’ decisions over commission payments and disadvantage independent research providers.
- 4.7** Our roundtable discussions indicate that the unpriced, bundled supply of research and execution by brokers contributes to a lack of transparency for investment managers in assessing value for money in the market for research. We heard views from brokers that pricing is difficult and that there are some benefits from the bundled model.
- 4.8** However, our observations of the market lead us to conclude that research pricing is both possible and desirable. We believe it would improve efficiency and the focus on quality by both providers and consumers of research, promoting more effective competition in the interests of end investors. Since market forces and existing regulation to date have not led to this outcome, we indicate that further reform may be needed.

#### **Investment managers’ controls and oversight of dealing commission costs and assessing the value of research**

##### **Existing efforts to control costs and value research services**

- 4.9** Discussions with both buy-side and sell-side firms suggest that many investment managers have sought to reduce the amounts paid through dealing commission for research, especially since our report in 2012.
- 4.10** However, changes are more difficult to detect in aggregate dealing commission figures. In part, this may be due to time lags in improvements by firms feeding through to lower commission payments, and changes in market activity making comparisons difficult. But there are also concerns that the conflicts of interest and opacity in the use of dealing commissions means gross payments will remain constant, either with limited change to research commission levels or any reduction being offset by more trading activity by managers in order to pay brokers.<sup>39</sup>
- 4.11** From comments made in our roundtables it is apparent that robust controls and valuation of research goods and service remains challenging and highly varied among investment managers. There was a clear consensus that much more rigour is needed in the valuation of research, although views were more varied on the main barriers to achieving this and how to drive sustained improvements.
- 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:
- Separate internal governance and decision-making processes to assess their research needs on a ‘bottom up’ basis (based on what will add value for their clients, versus those which do not) and identifying which providers can provide these services at the best price, that is distinct from decisions over where to direct trades.
  - Setting and managing a total research budget that is not influenced by trading volumes,

<sup>38</sup> IMA, ‘The use of dealing commission for the purchase of investment research’, p.13

<sup>39</sup> This view has been posited in comments from consumer representatives and in a Said Business School paper, ‘Does transparency overcome conflicts of interest? Evidence from investment managers and their brokers,’ by Mark Abrahamson, Tim Jenkinson & Miguel Sousa, Said Business School, Oxford University (March 2012).

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.

- Strong negotiations with brokers or other providers to ensure a desired payment level is agreed for the services actually required and valued, and conversely not rewarding research that doesn't add value even if it is still supplied.
- 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.
- Broker voting processes that ascribe a clear monetary value to each vote, and link the total amounts rewarded a broker as a result of 'votes' to actual services received over a period. Better 'broker vote' processes included internal challenge and comparisons to ensure that research is being consistently rewarded between different fund managers or desks within the firm. This sought to reduce the risk – acknowledged by a number of investment managers – that individual fund managers may seek to reward a minimum amount of commissions to a specific broker (regardless of the value of research received) to maintain a 'relationship'.

**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.

#### **The link between trading activity and research payments**

**4.14** Many investment managers still do not apply a sufficient level of control and oversight on research spending paid from dealing commission.

**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.

**4.16** Most stakeholders acknowledged that the link between dealing commissions paid for research and trading activity creates a potential conflict of interest between an investment manager and their customers, and different groups of customers. If an investment manager trades more frequently they will generate more research dealing commissions with brokers at a cost to their customers' funds. This could influence trading activity and decisions if the investment manager wants particular research services from a given broker, but either does not use CSAs or does not have sufficient commissions in a CSA elsewhere to pay the broker only for research.

- 4.17** A further conflict created by linking research payments to trading activity can occur where an investment manager trades more frequently in some of their funds than in others, but may use research commissions generated to buy goods and service that benefit less active funds. Similarly, where trades are aggregated across funds at bundled rates, commissions may be used to buy research from a specific broker that has no relevance to some of the investors included in that trade. As the Pensions Institute has recently stated:

Investment managers often get ‘free’ services in exchange for this commission... but these ‘free’ services are actually paid for by the client. The level of the services received increases with the level of business given to a broker, thereby providing an incentive to churn the client’s portfolio. Further, investment managers frequently aggregate different clients’ trades to get the best price. The aggregated trades will go through a particular broker which means that some of these clients will be indirectly paying for research which they get no benefit (for example, because the broker specialises in research about a segment of the market in which the client does not invest).<sup>40</sup>

- 4.18** A reliance on bundled rates can also mean an investment manager is unable to pay a broker or third party research provider offering them research they really value over a period if they don’t execute trades with them. This issue was mentioned by both investment managers and research providers. Research commissions will instead be directed to a preferred executing broker. An investment manager may therefore be over-paying for research they don’t really want or value. This also distorts competition for research, as an investment manager is limiting their external research input to brokers, ignoring a wider diversity of independent research providers, who may offer better value for money goods and services.

#### **External research as a core cost of business for investment managers**

- 4.19** Most investment managers acknowledged that external research consumption can be broadly predicted and budgeted for, as with other relatively ‘fixed’ costs. An investment managers’ external research consumption is comparable to budgeting for how many in-house research analysts they need to employ and what industry sectors they focus on. The best controls by investment managers we have seen are where external research acquired with dealing commission is treated in the same way as the firm would treat goods or services procured with their own money, assessing first what research they need, and then what they are willing to pay for it.
- 4.20** However, because external research is funded through the transactional mechanism of dealing commissions paid on the execution of trades, and services are commonly bundled and unpriced, investment managers have to engineer a complex valuation process. Rather than allocate upfront funding for external research, an investment manager has to track and manage research commissions that are gradually accrued in trading with various counterparties – and retrospectively seek to value and pay providers for research.
- 4.21** As the IMA have noted, ‘the challenge arises out of the fact that payment for research is tied to the payment for trading execution but is not directly derived from that purchase, and unless controlled by proper governance, it risks both distorting the basis for the valuation of the payment and weakening its verifiability.’<sup>41</sup> From a regulatory perspective, we believe that better practices would emerge if the funding and payment mechanism for external research was better aligned with its nature as a fairly predictable cost borne directly by the investment manager.

<sup>40</sup> Pensions Institute (CASS Business School), ‘Discussion paper PI-1407: On the disclosure of costs of investment management’ by David Blake (May 2014), pp2-3.

<sup>41</sup> IMA, ‘The use of dealing commission for the purchase of investment research’, p.12

### *Use of budgets and CSAs*

- 4.22** Setting a budget is a good step for firms to take to better manage research commission costs and seek efficiencies in their consumption. However, based on our discussions, it is apparent that a budget does not mean a firm has necessarily considered their actual research needs, made a proper valuation of research, and then ensured payments are appropriate. Even where firms set budgets, the influence of trading volumes on research spending through dealing commissions can occur. Budgets are often set based on past years' research commission payment levels (which may have been linked to trading volumes), rather than based on a proper assessment of what research the investment manager values, and what they think it is worth.
- 4.23** The use of CSAs by investment managers can similarly help firms to control the use of dealing commissions, as described in paragraphs 3.9-3.13 above. Based on our discussions, most market participants view CSAs as an essential tool for investment managers to control and allocate dealing commission for research, and separate this from execution decisions. We share the view that, under our current rules, it is difficult to see how investment managers can ensure both best execution and appropriate payments for research are made without at least some use of CSAs.
- 4.24** Despite this fact, our review suggests that many firms still pay more commissions in bundled rates to brokers without using CSAs. Brokers also commented that the use of CSAs have plateaued in recent years, with most viewing them as more common among larger clients, but less so in a long tail of investment managers. Furthermore, even under CSAs, the total research commissions accumulated and paid out to reward research providers may still be influenced by trading volumes and trading decisions – often linked to the broker vote process used to allocate commissions (see below).
- 4.25** Evidence from our supervisory review of the largest integrated brokers suggests around half of dealing commission payments they received from UK investment managers were paid under CSA arrangements between Q4 2012 and Q3 2013. From CSA monies held by the broker, on average they retained around two thirds of these funds, with a third paid away to other parties. This means less than one fifth of the total dealing commissions received by larger brokers was paid away to other research providers.<sup>42</sup>
- 4.26** There also remain other weaknesses in the use of CSAs, which include:
- CSAs are complex and costly to administer, requiring careful reconciliations of dealing commissions, and there have been comments on whether CSA contractual terms are sufficiently strong, and how well cash balances are protected given they are held on brokers' or third parties' balance sheets.
  - The largest brokers are the main providers of CSAs for investment managers, which may influence the investment manager to continue to use that broker for execution rather than a different counterparty. It also means the broker can administer the pot in a way that disadvantages their research competitors – for example, by delaying payments – and knows which of its competitors the investment manager is choosing to pay from that CSA.
- 4.27** The initial emergence of CSAs did open up the market for other, non-broker research providers to be paid by investment managers and they facilitate the payment of more precise amounts to providers who set prices for their services. However, CSAs have not resulted in investment managers making value for money assessments of all research goods and services to break

<sup>42</sup> These figures are estimates based on returns from a sample of brokers included in our supervisory review. They reflect varying methods applied by the brokers in order to identify total commission levels and CSA payments from UK investment managers.

the link between research payments and trading volumes, nor have they resulted in a move to universal pricing of research. The largest brokers still attract a significant share of research commission payments, even via CSAs.

#### ***Valuation through the 'broker vote'***

**4.28** From our discussions, the 'broker vote' remains the primary means of seeking to 'value' and allocate dealing commission payment for research goods and services received by investment managers. While there are a few examples of better processes, from our conversations with stakeholders, as well as our supervisory review, we believe there are some inherent flaws in the broker vote as a means of 'valuing' research goods and services and ensuring appropriate levels of payment are made to providers. Shortcomings include:

- Some voting processes simply divide an accrued CSA pot generated by trade volumes - by the number of votes (e.g. by 100). This means the monetary value of a vote will vary, even if the vote by the investment manager is intended to reward the same level of goods and services over two periods of voting.
- Others firms allocate research commission votes to a desk explicitly linked to levels of trading over a period. Again, this links trading activity to research needs and budgets, which are not strictly related, and could encourage over consumption and/or over trading by desks to gain more votes and so achieve a greater research budget.
- Individual fund managers in a firm are often not aware of the monetary value of their vote. This does not encourage a proper value for money consideration of research received. 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.
- 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.

**4.29** The broker vote remains primarily a form of relative ranking tool. Most investment managers do not appear to centrally track what research they have actually received and consumed, to analyse it in the way that the brokers do to assess 'client profitability' (see below). There is little to suggest investment managers commonly consider whether allocating their own internal resources or obtaining independent research at a fixed price, could produce a similar output at a lower cost.

**4.30** The broker vote also encourages research providers to target as many 'touch points' at an investment manager as possible, to maximise votes across multiple fund managers and so gain higher levels of commission payments. This is not necessary an efficient way for the investment manager to consume inputs, but favours the breadth of services offered by the investment banks (discussed further below). It leads to an emphasis on a broad 'relationship', not the specific quality of research services.

**4.31** This has led to some investment managers stating they feel unable to reduce commission payments to investment banks below a certain threshold, to ensure they are still considered for wider ancillary services. This can include corporate access or, as the IMA noted, being "favoured or prejudiced in the allocations of IPOs, according to their payments of dealing commission".<sup>43</sup>

<sup>43</sup> IMA, 'The use of dealing commission for the purchase of investment research', p.19

- 4.32** Overall, we still have concerns about the controls and oversight applied by investment managers on the amounts spent on research services paid from dealing commissions, and efforts to value research. Despite the use of budgets and CSAs, trading volumes still significantly influence the level of research commissions. As a result, there remains a risk of over consumption, or over-payment, for both research and execution services.
- 4.33** However we also acknowledge comments from many investment managers that the lack of upfront pricing and the unwillingness of brokers to provide research services on a discrete basis pose a key challenge for managers to improve their own controls. We discuss these issues in more detail below.

### Transparency and disclosure of costs

- 4.34** The continued prevalence of using bundled dealing commissions to pay for services also means that end-investors won't know what services, and the value of those individual services, that are being paid for out of dealing commission as an additional cost to their funds. This is particularly the case where end investors focus on the annual management charge (AMC), where transaction costs, such as dealing commissions, are currently not included.<sup>44</sup>
- 4.35** It is clear from discussions that, even with existing disclosures on the amounts of dealing commission directed for research versus execution, it is difficult for the customer to judge the usefulness of research provided to the investment manager, or assess whether the amounts spent on external research are reasonable. There was a consensus that dealing commission disclosures are rarely challenged by investors.
- 4.36** Despite this agreement, many industry views suggested that better disclosure to customers could still improve the accountability of investment managers.<sup>45</sup> It was felt this may sufficiently mitigate the conflict of interest created by the use of dealing commissions to acquire external research and lead to better controls over commissions. It was also argued that investment managers are already incentivised to manage transaction costs, including dealing commissions, due to the overall impact on fund performance – which is transparent to customers.
- 4.37** Those expressing these views also pointed out that, if a future reform such as unbundling simply moved the same cost for external research from dealing commission charges into the AMC, there was no net benefit to customers in terms of returns. At the same time, investment managers were concerned that if 'unbundling' was considered only in the UK, and firms did increase their AMCs, this would make UK firms seem more expensive than international competitors based on headline charges.
- 4.38** We do not share these views. We believe better disclosure of dealing commission charges will still not provide sufficient scrutiny on investment managers to ensure they apply a similar degree of rigour in spending dealing commission as a firm would apply to spending its own money. Customers cannot assess the cost benefit of external research themselves and the value added it represents vis-à-vis the investment managers' own in-house research, nor compare these costs easily between different investment managers (especially if the manager's own 'valuation' process has weaknesses).

<sup>44</sup> In line with this principle, MiFID II reforms may in future require investment managers to include all costs – including 'transaction' costs - in a single figure disclosed to their clients (see Chapter 5).

<sup>45</sup> Both the IMA and CFA Society UK reports earlier this year proposed better disclosures as a main reform option to improve the use of dealing commissions and transparency to investors.

- 4.39** We do not believe the use of dealing commissions to fund research currently leads to an optimal level of payments or consumption by investment managers, which is implied by the view that the entire cost would be passed into AMCs. We discuss in Chapter 5 the potential impacts of reform options to 'unbundle' research from dealing commissions, at which point we also consider the points made above in relation to possible effects on competition, including in an international context.

#### **Transparency of execution costs**

- 4.40** Funding research through bundled dealing commission rates, with little transparency of what is being paid for, must also affect the assessment of execution rates. Investment managers must comply with our rules on best execution, as well as our rules on the use of dealing commission, and they are distinct obligations. While total costs of execution are complex, and the dealing commission rate is not the only element of the cost of a transaction (nor is cost the only criteria), it will be an important factor.
- 4.41** Firms often appear to make a purely arbitrary split in the headline bundled commission rate into 'execution' and 'research' components. This suggests that where bundled rates are used, the execution component may not reflect the true cost and value of the execution service, just as the research commissions may not reflect the value of actual research received. So many firms may not know whether they are really paying an appropriate 'bundled' execution rate given the types and volume of trading they carry out on behalf of their clients. Any disclosure of the execution versus research elements of dealing commission rates to customers will therefore be of limited benefit.

#### **Pricing and competition in the market for research**

- 4.42** This section explores why pricing has not emerged in the market for research, and whether, if it did, this enhanced transparency could promote more effective competition to the benefit of investment managers and underlying investors. We discuss the contrasts in business models of independent research providers and integrated brokers in supplying research, and the extent to which the use of dealing commission to pay for research drives a lack of efficiency in this market.

#### **Broker views on pricing services and the use of dealing commissions**

- 4.43** Some of the integrated brokers had considered pricing discrete services to a greater or lesser extent. One common barrier cited was that feedback from investment managers in negotiations and the broker vote process lacked detail. Brokers therefore feel unable to determine which of their goods and services are really valued, and which are not, to allow them to efficiently set prices.
- 4.44** There was also a sentiment from a number of investment banks that they could not price research, since the 'value' individual investment managers place on it will vary depending on how they use the broker's research. Brokers often felt the reward for their research should be commensurate to the size and scale of trading decisions an investment manager may make as a result of research received. This implies a form of 'equity stake' for the broker.
- 4.45** This contrasts with the investment managers, who argued that they need prices and more transparency from the sell-side to enable them to assess the value for money of the research they consume. There were views that the integrated brokers could price, if they were pushed, on a cost-plus basis. However, while some brokers conceded they could price research if they had to – and could be profitable – other brokers were unwilling to consider this. The latter

argued that as well as the lack of transparency from investment managers hampering price-setting, they were also unable to allocate costs to research as a discrete service due to wider cross-subsidies in their business.

**4.46** From our discussions at roundtables, brokers also commented on the benefits they perceived from the use of dealing commission and the retrospective broker vote method of allocating payments for research, rather than up front pricing. The main points included that:

- It gives investment managers the benefit of deciding what to pay for research goods and services after they've received and consumed that material.
- The reward and voting processes used by the buy-side best reflect the broad, holistic 'relationship' and multiple touch points and products offered by the large brokers, rather than itemising and valuing each discrete service or product.
- The dealing commission mechanism and bundled payments embeds positive cross-subsidies for investment managers, which the large integrated brokers absorb, including:
  - It accommodates cyclicalities, so that brokers accept lower research payments from investment managers in times of decreased trading activity and assets under management, but are compensated with higher payments for research in rising markets, while the level of research service to the manager is maintained.
  - Investment banks continue providing waterfront coverage to give market information and price-transparency in all sectors, often compared to a 'library service', even when an area may not be subject to much investor interest. This gives investment managers flexibility to consume research on a different sector periodically, without having to shift their fixed internal resources of their own analysts. It also aids liquidity in stock and shares, especially for smaller companies, as by maintaining continuous broker research coverage investors are more likely to trade and this liquidity helps companies to gain further access to capital markets when needed.
  - Brokers also argue that payment through dealing commissions embeds a cross-subsidy between sizes of investment manager, as large firms are likely to reward more for the same research than a smaller firm, where research payments retain a link to trading volumes. This helps the bank maintain waterfront coverage to all investment managers. It was argued this helps small investment managers in particular, who may rely more on broker research than their own in-house research, effectively 'outsourcing' more costs.

#### **The independent research provider business model**

**4.47** Most independent research providers, by contrast, ascribe a price to their services upfront. Some have developed a menu of subscription options, including specific sector or analyst access, or varying 'packages' of service levels. Many independents will specialise in specific sectors or areas, and therefore most compete on the quality and depth of their products and analysts' insights, over breadth. However, the nature of their research products and services are essentially the same as a large broker (e.g. written reports, models, direct access to research analysts).

**4.48** The largest research providers offer a similar breadth of coverage to investment banks. However, they still set prices or clear expectations of payments to investment managers, by contrast to the investment banks. The large independent research providers accept that, in setting a price, they need to accommodate a degree of margin that allows them some flexibility to maintain analysts and sectors that may at times be less widely demanded than others (internalising

this cross-subsidy). This demonstrates that pricing research is feasible, and a cost plus model can work.

- 4.49** However, independent research providers do have less scope to manage lags in revenues received for their services compared to large integrated brokers. They do not have the wider revenue streams from other services, such as dealing desks and the resulting flow of execution commissions from trading activities, or corporate broking, to 'loss-lead' with their research. So independent providers must instead demonstrate the quality of their research offering to secure an upfront price with the investment manager, and then continue to justify the value of their services for this fee.
- 4.50** Since some investment managers do not use CSAs, but rely purely on bundled payments for research and execution to brokers, independent research providers that do not have dealing desks will have to convince the investment manager their product is of sufficiently high quality that the investment manager will pay for it out of their own resources. This will make it much more difficult for the independent research provider to compete against bundled brokerage arrangements.
- 4.51** Due to these challenges, some independent research firms have evolved to add dealing desks, offering agency-only execution. Without dealing desks, independent research firms face a structural disadvantage within the market for providers of research. Many independent providers have noted the difficulty of getting on to investment managers' 'broker vote' lists (especially if their due diligence focuses on execution counterparty risk) and then securing sufficient, predictable payment levels to reflect the quality of services they provide and make their businesses sustainable.
- 4.52** Competition distortions are further exacerbated by the tax treatment of research. Based on HMRC's guidance on value-added tax (VAT), market participants generally appear to view bundled broker research as VAT-exempt. By contrast, goods and services from independent research providers paid for through CSAs or directly from an investment manager's own funds are more likely to be viewed as subject to VAT. This creates a further disadvantage for non-broker research suppliers.

#### **Brokers' ability to price research**

- 4.53** It is clearly possible for integrated brokers to price their research, as evidenced by independent research providers. Most of the large brokers already set a hard or soft expectation that investment clients should pay a minimum amount of £50,000-£100,000 per year in gross dealing commissions to access their research portal or distribution list for their written products.
- 4.54** Beyond this minimum service and payment level, investment banks strictly ration further value-added services, such as access to analysts or bespoke work, according to their highest paying clients – whether in dealing commissions or wider revenues. Investment banks closely monitor levels of commissions paid, versus the total research resources (or 'touch points') they provide to clients. If a client is deemed to be 'under paying' in this ranking, the brokers would first look to secure higher commission payments in future for their services, or if not to lower service levels to that client or cut off access accordingly. This indicates broker do implicitly set a revenue expectation and put a value on their services, which implies they could set a price.
- 4.55** Arguments that brokers could not price services, such as access to analysts for example, runs contrary not only to the independent research model, but also other markets in which access to individuals' expertise is priced. We did not hear convincing arguments for why a 'cost plus' model for access to analysts, for example, could not be used. Indeed, some brokers have considered 'weighting' the value of analyst time as well as access to other services, to help assess the total value of resources consumed by each client. As the IMA's Report noted:

[I]t is unclear why some system of price discovery cannot apply to the provision of research services. It applies to the provision of any other service in a competitive market, including that which – similar to research – involves a large suite of products and deals purely with intellectual capital. Moreover, price discovery incentivises the broker to deliver the best service for the investment manager; a relationship that is more difficult to sustain under a linked-price model.<sup>46</sup>

**4.56** The claim that brokers cannot judge the ‘value’ a fund manager obtains from research does not prevent price-setting. In pricing any product, a supplier makes a judgement as to where they believe the market will provide them with the optimal level of demand from customers and profitability from that revenue. Investment managers in our discussions felt strongly that brokers should be more transparent in pricing, and in a CFA Society UK survey earlier this year, only 16% of respondents agreed that the current UK market for research was transparent in terms of value and cost.<sup>47</sup>

**4.57** Brokers should not expect their payment for research to reflect a form of equity stake in the resulting investment decisions of the investment manager (which could equally be loss-making or result in a decision not to trade), since the broker takes no risk in a managers’ investment. It is also clear that any individual piece of research rarely leads, on its own, to a specific investment decision. Instead, multiple pieces of research and analysis will be considered by the investment manager in making investments for their customers.

#### ***Cross-subsidies in the bundled supply of research***

**4.58** Contrary to most brokers’ views in our discussions, we do not believe the use of dealing commissions to acquire research and the unpriced, bundled supply by brokers creates significant beneficial cross-subsidies for investment managers and the wider market.

**4.59** The strict rationing by investment banks of their more value-added research services, as well as minimum commission levels to access their core written product, undermines the claim that the bundled model provides significant cross-subsidies between larger and smaller investment managers. Several smaller investment managers stated they do not gain access to any value-added broker services where they have lower commission levels; a view supported by our supervisory work.

**4.60** Many investment managers also state that most broker ‘maintenance’ research is either unread or has little added value. They do not support the idea that this broad ‘library service’ from every large broker is essential. It is unclear why an investment manager would need this facility from more than one or two brokers, and this continued feature of brokers’ services seems to imply potential over-production and a lack of specialisation in the market. If brokers can maintain such significant capacity across an industry, this could suggest investment managers’ dealing commission payments are subsidising it (even if they may not value it), at a cost to investors; competition is not effective enough to rationalise the supply of research; or brokers obtain wider benefits from their own research unconnected to cash equities.

**4.61** If an investment manager only lacks expertise in a specific sector, the optimal purchasing decision for the investment manager may be to acquire individual sector-coverage from a broker or independent provider. However, the bundled waterfront service by investment banks prevents such efficient purchasing decisions.

<sup>46</sup> IMA, *The use of dealing commission for the purchase of investment research*, p.14

<sup>47</sup> CFA Society UK, *The Market for Research* (February 2014), Annex C

- 4.62** It appears that investment banks rely on their own broad, all-sector equity research coverage in part to facilitate their own wider activities. This may include their desire to take proprietary positions in equities or as a general marketing tool to attract order flow. We note that the one broker in our supervisory work that had completely separated their research function from execution services had, as a result, focused on the depth and quality of their research in a smaller number of sectors, rather than offering blanket coverage of all sectors.
- 4.63** It is evident that most investment banks use their broad research coverage for their other non-equity activities, such as fixed income or derivatives trading, and to aid their investment banking activity. As a recent McLagan report notes on investment banks' research function:
- The fact that research can be leveraged across banking, equities and fixed income has made it even harder to quantify value...it is important not only for the sales force across markets, but also the investment banking business, where it plays an important role in helping banks win equity capital market mandates.<sup>48</sup>
- 4.64** It is the investment banks' own internal use of research, and the fact that they also allocate their equity research resources to clients based on their global and cross-product line revenues, which also drives their unwillingness to price it. Investment banks would need to assess where the costs of their research are actually absorbed, and if this contributes to specific revenues, before they could price specific services to their cash equities clients.
- 4.65** From this perspective, the investment bank's preference for retrospective broker voting valuation processes rather than upfront pricing is more easily understood. Broker voting is more likely to favour their ability to maximise the quantity of touch points and supply waterfront coverage – which the banks want for their own wider business needs. In more informal valuation processes, they are also more likely to benefit from any 'halo' effect from providing wider, even though sometimes ineligible, services such as corporate access, which most independent research providers don't offer.
- 4.66** For a broker, providing a priced research service to investment managers with the optionality to pick and choose to pay only for certain services – for example, access to a single sector of research coverage – simply means the broker may receive less revenue to cover the costs of the broad coverage that they want to provide in any case. The investment banks would also face more direct competition from independent research providers, with more pressure to demonstrate the added value of their research proposition to investment manager. This is likely to mean "high quality, content led research will become a differentiator."<sup>49</sup>
- 4.67** From our discussions, it appears that independent research providers and specialist brokers offer the more in-depth sector coverage of mid and small cap UK companies, for example UK AIM listed companies. Alternatively, companies rely on issuer-sponsored research where they already receive no coverage. The integrated brokers, by contrast, view such coverage as less profitable as it does not generate significant wider revenues for them, e.g. in secondary trading activity. Since the large brokers still receive significant levels of dealing commissions for research due to the continued link between these payments and trading activity, even via CSAs, the argument that dealing commission aids more research coverage of small companies is unconvincing.
- 4.68** Overall, while there may be short-term challenges for some market participants, there seems to be no reason why a priced market for research could not function. We have listened to views

48 McLagan, 'Changing Times: Quantifying Research' by Peter Bentley and Tyrone Jansen (May 2014), pp.1-3.  
Source: [www.mclagan.com/Alerts/20140501/images/McLagan\\_Alert\\_QuantifyingResearch.pdf](http://www.mclagan.com/Alerts/20140501/images/McLagan_Alert_QuantifyingResearch.pdf)

49 McLagan, 'Changing Times: Quantifying Research,' p.5.

that the unpriced, bundled supply of research by brokers in return for dealing commissions offers wider benefits. However, we do not find these compelling. We believe a priced market for research would promote more effective competition in the provision of research, to the benefit of investment managers and their customers. We agree with the summary in the CFA Society's report that:

Explicit pricing of external research would improve the economic efficiency of the market and would allow consumers more easily to make ex ante judgments as to which investment approaches they wished to support. Explicit external research pricing would allow better comparison with the cost and value of internal research teams and may diminish the over-supply and over-consumption of research.<sup>50</sup>

### Wider conflicts in the investment banking model – corporate access

- 4.69** As we discussed in Chapter 3, in relation to corporate access, some brokers had given little consideration to the potential for conflicts of interest. In particular, this seems relevant when brokers are determining the most suitable investors to put in front of a corporate, while at the same time satisfying an investment manager's desire to meet that corporate, especially when the latter pays considerable sums in dealing commissions.
- 4.70** We also spoke to corporates to gain their perspective as a customer to investment banks who provide corporate access and wider corporate broking services for them. We found larger corporates (e.g. FTSE 100) do not typically pay corporate brokers a fee, with the suggestion being that brokers provide this service in anticipation of trading volume in that corporate's stock or fees on future corporate actions by that corporate (e.g. capital raising). So the largest corporates can effectively outsource a significant element of their investor relations to brokers for free.
- 4.71** The loss-leading approach to large corporates by brokers may also, in part, have been offset by monetising corporate access to their investment clients alongside execution and research provision, prior to the FSA's Report and Dear CEO letter in 2012.
- 4.72** By contrast, a similar corporate broking service that brokers supplied for 'free' to large corporates had to be paid for by FTSE 250 and AIM companies by way of a retainer. This is likely to reflect the lower potential future revenues mid and small-cap companies are likely to offer to brokers in other areas, across their multiple business lines.
- 4.73** We will continue to monitor practices around the allocation of corporate access. If we see further issues in this area we may consider whether it is appropriate for brokers to have similar controls and policies in allocating corporate access as they currently have for IPO allocations, subject to compatibility with EU law.

<sup>50</sup> CFA Society UK, *The Market for Research*, p.12.

## 5.

# Options for change and a cost benefit and competition analysis

### Options for change

- 5.1** Based on our review and the lack of progress since introducing our rules in 2006, we conclude that more incremental regulatory change and supervisory oversight is unlikely to provide investment managers or brokers supplying research with sufficient incentives to drive greater transparency and improved outcomes for investors. We think a more efficient approach would be to impose more structural regulatory change that makes payment mechanisms clearer and lets the market, through more effective competition, work to improve market outcomes.
- A preference for unbundling research from commissions across the EU**
- 5.2** We believe the alignment of commercial incentives for investment managers to manage costs when acquiring external research, by making it a direct cost rather than one priced into transaction costs, could prevent ongoing issues of a lack of effective oversight in this area. If costs are poorly managed, the most immediate impact would be on the investment manager's bottom line and not on their customers' funds. It would remove the complexity of our regulations, with firms no longer needing to reverse engineer attempts to value and budget for research via dealing commissions.
- 5.3** Unbundling research from dealing commissions will give investment managers a commercial incentive to manage a fixed budget, with a more objective and efficient approach to procuring and valuing research. This would imply developing clear procurement process and contractual relationships to obtain the research they need, with no reference to or influence from trading volumes and decisions.
- 5.4** We believe it is unlikely that most investment managers would choose to pay for research based on the 'broker vote' if they were using their own funds. Instead, they would require research providers to set an upfront price for an agreed level and quality of goods and services supplied, which they would review on an ongoing basis. We expect that unbundling research from commissions would create sufficient behavioural change that suppliers, including brokers, would have to price all research in the market.
- 5.5** More rigorous governance by the investment manager will also reduce the influence of the wider relationships between fund managers and brokers, and the inference that corporate access or access to IPOs are informally rewarded in commission payments.<sup>51</sup> The investment manager will focus on the substance of research goods and services provided; only paying for

<sup>51</sup> A study in 2008 by Babson College and the Universities of Georgia and Missouri found evidence that fund managers engage in 'churning' portfolios and paying 'abnormal' commission levels to improve their prospects of gaining broker allocations of IPOs. Goldstein, M.A, Paul J Irvine and W. Andy Puckett, 'Purchasing IPOs with commissions: Theoretical predictions and empirical results' (June 2008), Babson College and Universities of Georgia and Missouri.

what they value. The pricing of execution will also be clearer in the absence of ‘bundled’ rates that include payments for research.

- 5.6** An unbundled research market may still involve a significant level of supply from brokers. However, they would need to make the kind of judgements in pricing and how to specialise and differentiate their research offering that independent providers have already had to develop. For example, brokers may set upfront fees for their written research or contractually agreed service levels for access to analysts. This should improve competition, reducing barriers to non-broker research providers and focusing on the price and quality of services offered.
- 5.7** We discuss the wider potential benefits, costs and competitive effects of two possible options for change based on current MiFID II proposals in the remainder of this chapter, including issues such as the possible impacts on the level of research coverage in the market, and the effects on liquidity in equity trading.

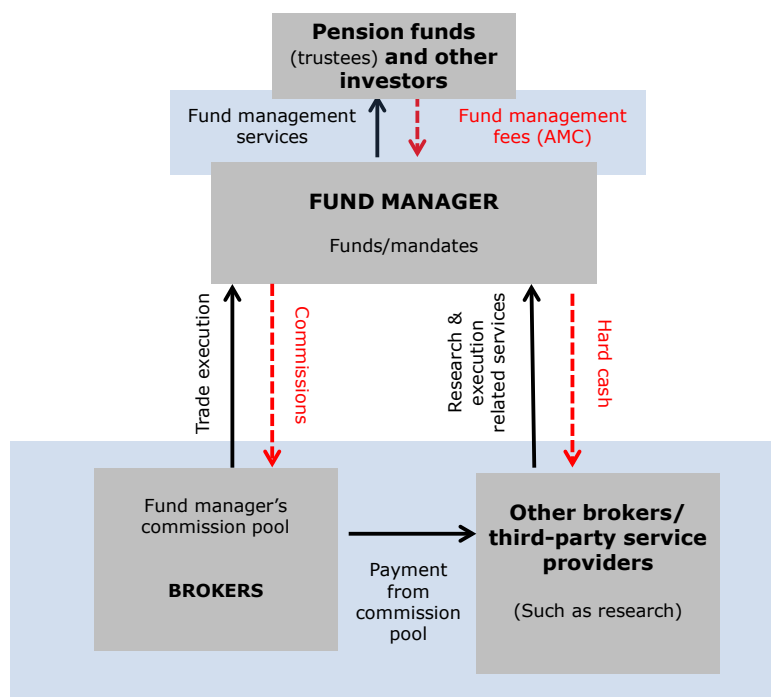
#### **Limitations of more incremental reform**

- 5.8** We have recognised that a combination of existing best practices in governance and controls, seen in a handful of investment managers, can help address some of the issues in the current regime. A number of stakeholders have suggested that an alternative approach to unbundling is to mandate a variety of these features within the framework of our current rules. This could include requiring investment managers to have separate internal governance to assess spending on research through dealing commissions and mandating the use of CSAs.
- 5.9** Discussions also covered the potential for regulation to require brokers to price their research services. More transparency would improve investment managers’ ability to assess and value research goods and services to the benefit of their customers. Improved disclosures by investment managers to their customers were also frequently discussed, with the IMA’s recent report committing to review their disclosure codes.
- 5.10** However, MiFID II Level 1 and ESMA’s proposals for MiFID II Level 2 on inducements restrictions for portfolio managers would supersede more incremental changes. At the same time, MiFID II changes do require new ‘total cost disclosures’ to clients to include all associated costs of a product or service, which may include transaction costs, making charges more visible to customers in a single headline figure.
- 5.11** We also believe incremental changes will not offer the full benefits of aligning investment managers’ incentives with those of their customers and promoting more effective competition. Governance and disclosure requirements would add further regulatory burdens on firms to mitigate an inherent conflict of interest our rules have created by allowing the use of dealing commissions to acquire research. It would rely on close regulatory scrutiny and a negative threat of intervention if more proscriptive rules were not met. The lack of significant improvements since 2006, despite more recent supervisory scrutiny, indicates this approach is unlikely to be effective.
- 5.12** On that basis, we have not considered the costs and benefits of mandating certain governance arrangements or the pricing of research services as alternative options in this DP, nor more radical options, such as requiring investment managers to also pay for execution costs with their own money. Instead, we discuss options based on the inducements position in MiFID II Level 1 and ESMA’s consultation.

### Defining the market

- 5.13** The fund management market is particularly large. UK fund managers managed around £5trn of assets at the end of 2012<sup>52</sup>, and accounted for around 36% of assets under management (AUM) in Europe<sup>53</sup> - the single largest asset management centre in Europe. £1.8trn of UK AUM are managed on behalf of overseas clients.<sup>54</sup> Approximately £1.6trn of AUM relate to active equity mandates.<sup>55</sup>
- 5.14** Investment managers purchase services from brokers and other research providers on behalf of pension fund trustees and other investors. Brokers provide both execution services and wider services such as research, while other third parties are more specialised, such as independent research providers.
- 5.15** Investment managers use the services of brokers as an input to produce investment management services that are then bought by different types of investors.

**Figure 1: A stylized description of the value chain**



### Demand side

- 5.16** Investment managers manage funds on behalf of wholesale and retail clients. They manage a range of asset classes, including cash equities. Dealing commission is used by investment

52 IMA survey, *Asset Management in the UK 2012-2013* (August 2013) states their members managed £4.5trn of assets in the UK, representing 85% of the estimated £5.2 trn managed by the wider UK asset management industry as at December 2012 (p11).

53 Bank of America Merrill Lynch, 'Commission unbundling – the debate resurfaces' (2014).

54 Bank of America Merrill Lynch, 'Commission unbundling – the debate resurfaces'.

55 Estimates derived from data in the IMA survey and Bank of America Merrill Lynch, 'Commission unbundling – the debate resurfaces'. £5 trn UK AUMs x 42% of AUM with equity content x 78% of those with equity content are actively managed.

managers to pay for execution costs and certain research costs.<sup>56</sup> It is taken directly from client funds, rather than charged to investment managers' themselves (and as such it does not directly influence investment managers' profitability). Use of dealing commissions for research is mainly relevant for active cash equity mandates and less so for passive cash equity mandates where trading is only necessary to replicate a specified index and there is little if any need for research to inform trading decisions.

- 5.17** Dealing commission is not used to pay for trade execution in all asset classes. However, since our rules in COBS 11.6 only apply to equities and related derivatives transactions, our current analysis is focused primarily on investment managers trading in equities.

### **Supply side**

- 5.18** Brokers (including investment banks) provide trade execution and research services to investment managers. They also provide a range of other services to investment managers; for example, corporate access. Our rules in COBS 11.6 allow certain research to be paid for, along with execution services, from dealing commission i.e. taken directly from the clients' funds.<sup>57</sup>

- 5.19** Independent research providers also supply research services to investment managers on a standalone basis. They tend to provide more specialised services or bespoke pieces of research, which are normally paid either out of investment managers' funds or from dealing commissions in their CSAs, and the dominant payment model is fixed/ subscription fee.<sup>58</sup>

- 5.20** Estimates suggest that around £1bn to £1.5bn of dealing commissions was used by UK investment managers to acquire research in 2012.<sup>59</sup> Independent research providers currently have a much smaller share of the research market than brokers. Approximately £250m was spent on independent research across Europe in 2011.<sup>60</sup>

### **Interaction with other asset classes**

- 5.21** Cash equities represent approximately 40% of all mandates in the UK. This implies that other asset classes account for the remaining 60%. These other market segments such as fixed income, foreign exchange and commodities are not subject to our specific rules on the use of dealing commission. Also, in some cases, the cost of trading is represented by the bid-offer spread, which is captured by brokers and not by ad valorem commission fees.

- 5.22** This still represents a cost borne by the underlying client of an investment manager. Some research may be supplied to investment managers in return for non-equity trading, whether linked to overall volume of trading with a broker or increased 'spreads' on some trades. As we have discussed above, brokers will consider wider business conducted by an investment manager in areas such as fixed income, when prioritising and tiering their research clients and allocation of resources.

- 5.23** However, whether costs of research do have any marginal impact on spreads for other instruments is less easy to detect and quantify. This area has not been considered in this high-level cost benefit analysis.

<sup>56</sup> See COBS 11.6

<sup>57</sup> As set out in COBS 11.6 and recently clarified following PS14/7.

<sup>58</sup> Centre for the Study of Financial Innovation (CSFI) report by Vince Heaney, 'Independent Research: because they're worth it' (November 2012)

<sup>59</sup> The lower-end estimate is based on a report by Bank of America Merrill Lynch, 'Commission unbundling – the debate resurfaces' and higher-end estimate from CP13/17.

<sup>60</sup> CSFI report by Vince Heaney, 'Has Independent research come of age?' (June 2011)

- 5.24** We are mindful that changes proposed under MiFID II do not distinguish between asset classes. Investment managers would not be able to receive valuable research from a broker as an inducement for execution services across a number of asset classes. This means an investment manager's arrangements and purchasing decisions for research – whether focused on or related to equities or other forms of investments – would need to be the same.

#### **Problems within the current market**

- 5.25** As noted in previous chapters, evidence suggests that the current regime does not fully address a number of market failures. Ineffective competition remains, with a lack of transparency resulting in insufficient scrutiny (by both end investors and investment managers) of costs paid directly from client funds (i.e. dealing commission). So there are insufficient incentives for investment managers to ensure they achieve value for money when purchasing research (and to some extent trade execution) services from dealing commission.
- 5.26** This can lead to over-consumption of research, excessive dealing (with investment firms having an incentive to deal more frequently than is in the interest of the end investor) and to the quality of research and trade execution goods and services provided by the market being lower than might rationally be demanded.

#### **Changes in the European regulatory landscape and the options discussed**

- 5.27** In both previous and more recent discussions in this area, many UK firms were concerned that, if the UK unilaterally required unbundling, they will be put at a competitive disadvantage compared to other firms active in the EEA. Many of these concerns would be considerably less relevant in the future, given the Level 1 text of MiFID II and the current position of ESMA.
- 5.28** MiFID II may in effect ban the bundling of research with dealing commission arrangements. As set out earlier in this document, the final Level 1 proposals for MiFID II indicate a significant restriction on the ability of portfolio managers to receive inducements. The recent ESMA consultation paper further indicates that Level 2 may confirm a narrow reading of the limited exception to this ban, for minor non-monetary benefits. In addition, MiFID II Level 1 also permits Member States to impose further restrictions at national level around the acceptance of fees, commissions or non-monetary benefits, where necessary, to enhance investor protection.<sup>61</sup>
- 5.29** It could be that changes in MiFID II, in effect, mean dealing commission is prohibited across Europe. However, even if MiFID II does not go this far, the changes it does propose in relation to inducements could mean the incremental compliance costs of, either partial or full, unbundling of research are significantly reduced, as firms would have to implement them at the same time as other changes envisaged by MiFID II in this area.
- 5.30** Even if ESMA rules on inducements end up being less stringent than currently envisaged, proposed MiFID II rules on disclosure of fund charges imply that even if the UK unilaterally requires unbundling of research - although we are not considering the option at this stage - it is unlikely to put the UK investment management sector at a significant competitive disadvantage. Currently, dealing commission is not reflected in the headline costs of a fund (i.e. reflected in the AMC), so unbundling in the UK alone would make UK funds look relatively more expensive to investors across Europe.

<sup>61</sup> MiFID II Level 1, Article 24(12)

- 5.31** This could theoretically put UK investment managers at a competitive disadvantage if investors only compare headline prices. However, in future, MiFID II will require European investment managers to disclose to investors in a single figure the total cost of a particular fund, including costs taken directly from clients' funds (e.g. dealing commission), which has the potential to become the new 'headline' price. So this concern is of much more limited significance within the EEA.
- 5.32** Given that unbundling will provide UK investment managers and brokers with strong incentives to become more efficient and charge prices that more closely reflect the cost of provision of research and trading services, total costs of funds in the UK (relative to the rest of Europe) could be lower as a result.
- 5.33** There are two main options discussed in this DP. The first is essentially to support the current position of ESMA that allows research to be within the inducement rules if it is very generic and widely distributed. The second is to go beyond the current ESMA position and not to allow any research to be received by investment managers linked to execution arrangements.

### The effect of the policy options

- 5.34** In this section we summarise the implications of implementing the current approach envisaged in the ESMA consultation (option i) or going beyond them by requiring the unbundling of all research from execution arrangements (option ii). Although it is a possibility, we do not discuss here the effects of requiring investment managers to pay for execution costs with their own money.
- 5.35** In discussing the effects, we take the agreed Level 1 text and the recent ESMA CP as a starting point, although we recognise that ESMA's position could change following the consultation period and that the Commission may not follow ESMA's advice. We acknowledge that the final rules under MiFID II could still be more or less stringent than those currently envisaged by ESMA.

### Wider outcomes and the impact of research unbundling

- 5.36** We recognise from our previous work on this issue that a move towards unbundling of research, in the ways envisaged by both option i and option ii, could have a number of impacts on the market. Based on the FSA's previous work in developing the current regime and recent research developed by external parties, we anticipate that the main impacts of any regulatory change will arise in the following areas:
- market integrity and effective competition – both between firms in the UK market and the ability of UK investment managers to compete internationally
  - the supply of, and demand for, research
  - the quality of equity trading and liquidity
  - the tax treatment of bundled goods and services
- 5.37** These issues are outlined below and we highlight, where relevant, the findings from the FSA's previous analysis and our current understanding, based on market and regulatory developments.

**5.38** Table 1 summarises the main effects of the two options:

| <b>Impact on</b>                         | <b>Option i) Unbundle all, except generic, research from dealing commission<br/>(Current MiFID II proposals)</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    | <b>Option (ii): unbundle all research from dealing commission</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Competition in research market</b>    | <p>Expect it will improve competition. However, this option presents more opportunity for firms to interpret 'generic research' more widely than intended and there is a concern firms could use this as an excuse to inflate dealing commissions or influence where order flow is directed.</p> <p>Potential number of suppliers of research increases and more tailored and innovative products can be developed.</p>                                                                                                                                                                                                                                                                                                                                                             | <p>Likely to improve competition in the research market and outcomes for the end-investor. In particular, expect it provides greater incentives for investment managers to secure value for money when purchasing research (outcomes likely to be improvement in the quality, and reduce cost of, research provided by the market).</p> <p>Investment managers more likely to consider purchasing from independent research providers (IRPs). As such IRPs may provide a greater constraint on research provided by brokers.</p> <p>Potential number of suppliers of research increases and more tailored and innovative products can be developed.</p> <p>Don't expect, given other MiFID II proposed changes, that UK firms would be put at a competitive disadvantage.</p> |
| <b>Research markets (more generally)</b> | <p>Similar impacts for each option. Don't expect research coverage will reduce as:</p> <ul style="list-style-type: none"> <li>• Investment managers still need to access a flow of investment ideas and will be prepared to pay for value-added external research</li> <li>• Brokers need to produce in-house research for other purposes (e.g. inform in-house trading strategies)</li> <li>• Facilitates independent research providers to compete more effectively in the market – expect this will drive up the quality of research, and drive down prices, in the research market</li> <li>• There remain other sources of research that will be unaffected by these changes, such as issuer-sponsored research and research commissioned by exchanges<sup>62</sup></li> </ul> |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
| <b>Market integrity</b>                  | Improves transparency and accountability of investment manager spending on behalf of the end-investor, reducing the perception of conflicts of interest throughout the investment chain (but by less than option ii)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                | Has a greater ability to improve transparency and accountability of investment manager spending on behalf of the end-investor, reducing the perception of conflicts of interest throughout the investment chain than option i.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| <b>Quality of equity trading</b>         | <p>Similar impacts for each option.</p> <p>Expect it won't limit impact on firms ability to provide best execution for their clients and could improve quality of equity trading</p> <p>Also, competition between trading venues is likely to constrain spreads on equity trading – so we don't expect them to widen</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                            |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
| <b>Tax</b>                               | Research services provided outside of dealing commission will be subject to taxation (a transfer from affected firms to HMRC). Less prominent for option (i) given some research could still be received linked to execution arrangements.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |

<sup>62</sup> As noted in a recent report by Edison, The Future of Equity Research (January 2014)

***Effective competition and the competitiveness of UK firms***

- 5.39** The potential impact of unbundling research on the competitiveness of UK firms has broadly two dimensions: competition between firms within the UK market, and the ability of UK firms to compete internationally. The impacts would be slightly different between option i and option ii, as in the latter case UK firms would be subject to slightly more stringent requirements than other EEA firms (assuming the final MiFID II proposals do not prevent the acceptance of all research).
- 5.40** The FCA has market integrity and effective competition as part of its operational objectives for the regulation of UK financial services. We have emphasised that promoting the efficient operation of financial markets is a key concern where poor behaviours by wholesale market participants have a wider impact on areas such as charges and fees, which then ultimately feed through to final consumers.
- 5.41** Using dealing commissions to pay for certain goods and services is an example of an area where misaligned incentives between providers and end-investors as well as poor transparency makes competition less effective and leads to actual or perceived conflicts of interest between wholesale firms and their end client, with higher costs to clients a possible result of this. Investment managers are, after all, custodians of individuals' pensions, general savings, or funds that underpin insurance products.
- 5.42** It is in this context we believe that both options discussed may promote better market integrity and more effective competition in the interests of consumers. Making the costs of investment management transparent enables customers to make a more informed and so better choice of investment manager with more trust in the integrity of the market.
- 5.43** This may move us further towards the kind of market we desire, one that drives positive incentives through the investment chain, rather than trying to correct potentially inappropriate incentives and conflicting interests between market participants with more regulatory intervention.
- 5.44** Both options discussed, increase the competitive pressure on investment managers to offer value for money in relation to research goods and services – to keep costs low while maintaining performance. This incentive to keep research costs low would increase competitive pressure on brokers (and to some extent independent research providers) to offer better value. Greater transparency of research and trade execution costs is likely to improve the effectiveness of competition in both the brokerage and research markets involved.
- 5.45** We also expect that unbundling will reduce distortions caused by current regulatory distinctions and firm responses to these. Current regulation provides an incentive for firms to assign costs to execution or research and bundle products together so they can slot into this, harming the ability of specialist firms to compete on one element alone.
- 5.46** Brokers performing a range of services will have to ensure each element offers value for money, in order to compete with firms who may specialise in only one area. This increase in competition will improve quality and drive down the costs of services that can no longer be paid for through dealing commission. Investment managers will need to make one or a combination of changes to their business model, including:
- Absorbing costs into their 'bottom line' to keep their AMCs at the same level.
  - Considering the amount of research they purchase or finding savings by efficiencies in their consumption of research (better value for money).

- In some cases, investment managers will pass on some costs to clients through increases to their AMCs. But to do this while retaining clients, who could simply move managers, they will likely need to clearly justify to their clients the benefits they obtain for a higher charge versus their competitors – e.g. by demonstrating better investment performance.
- 5.47** To the extent that the first two approaches are taken and execution commission rates are lower since they no longer embed payments for research, this will directly reduce costs for investors, improving returns. Meanwhile, if investment managers increase AMCs, the client will not necessarily be paying any more, since any charge increase should not exceed costs they previously paid via dealing commissions: investment managers may buy less research or the same amount of research but they are unlikely to spend more than they currently do.
- 5.48** The fact that payments for research have historically been bundled with equity commission makes it difficult for independent research providers to compete with the in-house services of brokers. Members of the UK CFA society in a survey last year reflected this view: only 37% of respondents believed that buy side firms should use a client's money to pay for research, and nearly 60% believed that the current market framework does not best serve the interest of investors.<sup>63</sup>
- 5.49** Both options discussed should therefore favour the emergence of providers that can offer high quality services to investors and are not perceived as being more expensive only because they have to be paid with 'hard' money.
- 5.50** This would increase the potential supply of research considerably: from a limited number of brokers with internal research capacity to hundreds of third parties. This should result in a market where the specific needs of investors can be taken into account by research providers and a wider variety of services are developed in terms of different coverage, price structures and distribution models, among other features.
- 5.51** A recent study conducted on US mutual funds also suggests that, not only do investors overlook costs that are bundled with dealing commission, but also that the opaque costs are those that are most detrimental to performance.<sup>64</sup> As such, transparent and easily comparable costs would improve the overall functioning of the market.
- 5.52** Overall, both options should encourage effective competition: more potential suppliers will be available on the market; investors will find it easier to compare the cost of the services provided by such suppliers; and more tailor-made and innovative services should arise.
- 5.53** We are aware that, in the short term, all investment managers may incur higher costs if research unbundling is mandated (for example, they may need to spend more time proactively identifying research that is necessary to inform trading decisions and manage relationships with multiple suppliers).
- 5.54** Although this may in turn cause some competitive distortions both within the UK market and for UK firms competing internationally, we do not expect distortions to be significant. For example it has been argued smaller investment managers would be disproportionately affected, because they would be less able to absorb the costs or else less successful at passing them on to clients. However, in the medium to long term the situation would not be different to the status quo in this respect. Smaller firms would not incur larger ongoing costs than they currently do, nor would they be in a worse relative position vis-à-vis larger firms.

<sup>63</sup> CFA Society of the United Kingdom, 'Survey on the future of investment research' (2013)

<sup>64</sup> Edelen, R. Evans, R.B. and Kadlec, G.B., 'Disclosure and agency conflict: Evidence from mutual fund commission bundling', *Journal of Financial Economics*, Volume 103, Issue 2, February 2012, Pages 308–326

**5.55** On the international front, the argument has in the past been that such a change would:

- make it more difficult for UK firms to win and retain foreign mandates
- allow firms with international capability to conduct regulatory arbitrage, giving them an unfair advantage over UK-only firms
- deter investment management start-ups in the UK
- incentivise some firms to relocate part or all of their UK operations to other jurisdictions

**5.56** These considerations are somewhat more relevant for option ii where the UK does not permit any research to be bought with the fund's money, as in option i all EEA firms would be subject to the same rules and the options for UK firms to move business to other jurisdictions would be considerably limited. However, even if option ii is adopted, the type of research that other European firms outside the UK would be able to receive should be of such limited value that, in practice, it would not disadvantage UK firms.

**5.57** In addition, we don't expect either option, if implemented, would significantly affect the ability of UK firms to compete with investment managers that operate in jurisdictions (such as the US) that allow 'soft commissions' (or arrangements similar to dealing commission) for a number of reasons:

- First, it is unlikely that UK investment managers would be directly competing with firms outside the EU, as many retail and some institutional investors would likely prefer local managers.<sup>65</sup>
- Second, the outcome of the proposed changes would be a more efficient asset management sector in the UK, potentially offering a lower cost proposition, which should enhance the UK's ability to compete internationally.
- Third, the influence of changes in the EU may well drive changes along global lines for the largest asset managers, who will seek to comply on a global basis to the highest standards and would struggle to justify to their customers why they would adopt a lower standard in other markets given their fiduciary duties.

**5.58** For the same reasons, we do not see specific barriers for UK investment management start-ups or a significant incentive for UK firms to re-locate to other jurisdictions. As discussed in Chapter 4, we do not believe the ability to use dealing commissions to fund research significantly affects levels of research coverage, nor does it have particular benefits for smaller managers, such that unbundling would create a barrier to entry.

<sup>65</sup> Where institutional investors are more sophisticated and do look across multiple regions for an investment manager, they are likely to be aware of variations in which costs are included in headline AMCs in different jurisdictions and would conduct a detailed analysis to compare charges on a like-for-like basis.

### *The supply of, and demand for, research*

- 5.59** A second issue is whether any of the options discussed would compel investment managers to bear costs which they could not recover from their clients or profit margins. If so, they may spend less on research which in turn could reduce research coverage by brokers, resulting in less efficient trading with a consequent drag on funds' investment performance.
- 5.60** In this scenario, some stakeholders argued that there might be a disproportionate impact on the research coverage of the mid-cap and smaller company market, if brokers reacted to a fall in revenues by reducing their coverage of these sectors. This could, in turn, lead to less trading in the shares of smaller companies, damaging price formation and the ability of some corporates to raise capital through the equity markets.
- 5.61** However, procuring research to inform investment strategies and decisions appears to be a core constituent part of fund management as a service, and therefore it does not seem incongruous for investment managers to accept research spending as a standard cost of doing business.
- 5.62** We maintain the FSA's previous view, that clients fully recognise the need for active investment managers to access a flow of investment ideas and draw on research from many different sources to inform their decision making. Clients would expect to pay for this to secure the prospect of the levels of performance that active managers suggest are possible.<sup>66</sup>
- 5.63** While brokers might be expected to cut back on their research coverage, the precise impact is hard to assess. We believe that it is a reasonable assumption that active investment managers' continual search for stocks with real long-term growth potential is always likely to result in demand for coverage of small-cap and mid-cap stocks. We also expect that, as mentioned in Chapter 4, brokers will want to retain a wide range of in-house research for purposes other than selling to investment managers.
- 5.64** From our visits to brokers, it was also clear that most of the large investment banks' research focuses on breadth of coverage – i.e. to cover all global blue-chip companies and larger mid-caps. Most of the large investment banks covered several thousand stocks globally, but when asked about coverage of UK companies, this equated to research on 150-200 companies (e.g. the FTSE 100 and a smaller selection of the FTSE 250). Few specialise to cover a significant depth of smaller companies in the UK.
- 5.65** Instead, smaller UK firms tend to be covered by more specialist sector research, often carried out by independent research providers or smaller brokers. For some small companies, for whom there is already a lack of research coverage in any case, other forms of research provision have evolved, such as issuer-sponsored research or research provided by the exchanges on which they are listed.<sup>67</sup>
- 5.66** A move towards unbundling research may also help facilitate entry of independent research firms and enable them to exert a stronger competitive constraint on brokers' in-house research, improving the quality of research produced by the market. An unbundling model is likely to stimulate demand for value-added products, removing the link to trading activity favouring larger brokers, and increase the quality of research overall, which independent research providers would seem well placed to benefit from. The majority of independent research

<sup>66</sup> This was borne out by the findings of the Deloitte research for the FSA in 2004.  
Source: [www.fsa.gov.uk/pubs/policy/04\\_13/report.pdf](http://www.fsa.gov.uk/pubs/policy/04_13/report.pdf)

<sup>67</sup> Edison, *The Future of Equity Research* (January 2014)

houses are already paid, at least in part, through fixed fees/subscriptions and this is seen to provide a more reliable payment mechanism than trading commissions.<sup>68</sup>

- 5.67** We are aware there may also be tax implications, particularly around value added taxation (VAT). For VAT purposes, the supply of execution services for buying and selling securities is exempt from VAT, while the supply of advice and other forms of intermediation (such as research) is not. However, in practice, the tax system treats bundled broker commissions, that may include consideration for both execution and payment for the supply of research goods and services, as a single 'execution' service.
- 5.68** Any regulatory change that mandates separate arrangements and payment for the supply of research services from execution services could crystallise a liability for VAT on research where firms previously used bundling, resulting in a transfer from these firms to HM Revenue and Customs (HMRC). We would expect some of the firms' VAT costs to be passed on in prices, subject to the current level of competition in the industry and the ability of firms to reduce their profits.
- 5.69** While the FCA is neutral about such transfers of payment in broad terms, we believe that if this removed the distortion caused by the existing inequality of tax treatment between the provision of research under a separate agreement, versus research provided as part of a bundled service including execution, it would allow more effective competition. However, we will engage with HMRC to explore further the VAT implications of the two unbundling options and likely changes in behaviour by firms that may result.

***The impact on market spreads and liquidity***

- 5.70** Both the proposals discussed should have a limited impact on firms looking to provide best execution to their clients, especially when assessed in conjunction with the new MiFID requirements on the disclosure of fund charges.
- 5.71** A widely-held view at the time the FSA consulted on its rebate proposal, however, was that such a move could result in wider dealing spreads as brokers sought to maintain their margins or could prompt a shift to more opaque methods of trading. This concern was based on an underlying assumption that the cost impact of the proposals would be significant enough to prompt firms to react in this way.
- 5.72** The FSA's view, by contrast, was that investment managers would resist such moves and all participants had an interest in maintaining the transparency of the market that would counterbalance any potential interest in moving away from transparent trading venues.
- 5.73** Since this original analysis, the implementation of MiFID has further increased the competitiveness of regulated markets and introduced the concept of multilateral trading facilities (MTFs), reducing barriers to entry and resulting in lower costs of trading platforms.<sup>69</sup> We also note that MiFID II is likely to drive further transparency in trading venues. We believe the competitiveness of trading venues is likely to continue to act as a constraint on spreads widening in equity markets trading, despite arguments that unbundling of research from dealing commissions may widen spreads.
- 5.74** We also note that MiFID II will add more stringent best execution rules. We expect this will make it difficult for firms, if going forward we implement option (i) (unbundling all but generic research), to inflate dealing commissions.

<sup>68</sup> CSFI, 'Independent Research: because they're worth it'. This report indicates that nearly two thirds of fund managers pay for some independent research via fixed fees or subscription, and 30% have paid for research on an ad hoc basis.

<sup>69</sup> Oxera, *Monitoring prices, costs and volumes of trading and post-trading services: Report prepared for European Commission DG Internal Markets and Services* (May 2011)

**5.75** There is also a concern that if research was reduced on smaller companies, the loss of this information to the market would lower trading activity in those stocks, and this reduction in secondary market liquidity may act as a barrier for such businesses to raise further equity. We do not believe a significant drop in research is likely and so this consequence would be unlikely to arise. We would reiterate that if research supplied by a broker is genuinely of value to the investment manager, we expect they would continue to obtain both execution and research from the broker under an unbundled regime, albeit on a separate basis and with an explicit, upfront amount being paid for research.

**5.76** This supports the argument that execution costs should not significantly increase if research is unbundled. If this were to be the case for particular brokers this would most likely indicate a lack of competitiveness previously masked by gaining additional revenues (and profits) from bundled research or other services, which are judged by investment managers as providing limited value when their price can be easily observed.

**Q1: Do you have any comments on our analysis on the potential impact of unbundling payments for research from execution arrangements, based on MiFID II proposals?**

**Q2: Do you have any analysis that would help inform our view of possible benefits or costs of extending requirements in MiFID II to cover all research goods and services?**

## 6. Next steps

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### What do we want people to do next?

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- 6.1** Firms should consider our supervisory findings in Chapter 3 and seek to reflect our expectations in their ongoing activities. We expect investment managers, acting as agents on behalf of their clients, to ensure they manage their use of dealing commissions appropriately and in compliance with our current rules.
- 6.2** We also welcome submissions on the questions posed in Chapter 5 of this DP by **10 October 2014**.
- 6.3** We will also be keen to meet with stakeholders to provide opportunities for comments on this discussion and our analysis during this period.

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### What we will do next

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- 6.4** After the discussion period has closed, we will analyse responses and provide feedback. We will also seek to reflect on further development on MiFID II, following ESMA's consultation. We anticipate that ESMA will finalise their advice to the Commission by the end of 2014 or early 2015. We will therefore seek to time our response to this DP accordingly to also provide an update on the outcome of ESMA's consultation.
- 6.5** Further consideration of reforms to our use of dealing commission regime will coincide with implementation of MiFID II. On that basis, any further discussion or consultation on changes in this area beyond our update is likely to link to our wider work to implement MiFID II by early 2017.

# Annex 1

## List of questions

- Q1:** Do you have any comments on our analysis on the potential impact of unbundling payments for research from execution arrangements, based on MiFID II proposals?’
- Q2:** Do you have any analysis that would help inform our view of possible benefits or costs of extending requirements in MiFID II to cover all research goods and services?

**PUB REF: 004903**

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