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E-ALERT | Financial Institutions

December 2, 2013

THE FCA CONSULTS ON ITS USE OF DEALING COMMISSION RULES

On 25 November the Financial Conduct Authority ("FCA") published a consultation paper (CP13/17) on proposed amendments to its use of dealing commission rules contained within Chapter 11 of the Conduct of Business Sourcebook of the FCA Handbook ("COBS"). The consultation remains open for comments until 25 February 2014.

The proposed changes offer more precise guidance than the current rules as to when investment managers would and would not be allowed to bundle the costs of investment research into dealing commissions charged to clients.

BACKGROUND

In the consultation paper, the FCA notes that around £3bn was spent on dealing commissions last year, and estimates that roughly half of it was used by investment managers to purchase research. The FCA remains concerned that many firms have been using these commissions to pay for various services, including: investment research and market data services which do not relate to the particular transactions concerned; and corporate access and investor stewardship. Indeed, the Financial Services Authority ("FSA"), the FCA's predecessor, flagged these as issues in its November 2012 "Dear CEO" letter to asset managers on conflicts of interest. It was particularly concerned that certain investment managers did not have adequate systems and controls in place to ensure that their use of dealing commission complied with the FSA's rules.

Whilst it agrees behaviours have improved since the FSA's letter last year, the FCA is nonetheless keen to set out more explicitly what may or may not be purchased using dealing commission. There is still very much room for improvement. It states that "there remains some doubt about aspects of COBS 11.6, which in part has allowed investment managers to make judgements on what can be purchased with dealing commission that have gone beyond the intended perimeter of the rules".

PROPOSED RULE CHANGES

The FCA believes the proposed changes will clarify the rules and therefore improve its ability to supervise and, if necessary, take enforcement action on them.

The new rules contain more precise definitions of what research goods and services may be purchased, as well as those that may not. Under COBS 11.6.5E, research which:

- is capable of adding value to the investment providing new insights;
- represents original thought (whatever form its output takes), and does not merely repackage what has been presented before;
- has intellectual rigor; and
- involves analysis or manipulation of data to reach meaningful conclusions

will be more likely to be allowed, and therefore exempt from the bundling prohibition.

COBS 11.6.7G provides that historical price feeds and data may not be paid for with dealing commission. Guidance at COBS 11.6.8G sets out further a list (which is non-exhaustive) of research goods and services considered outside the scope of the rules. It includes seminar fees and publically available information. The investment manager must also not use commission to subsidise its own research and analysis. The FCA considers these to be core costs to an investment management business and they should therefore be paid for by the business. COBS 11.6.8AG provides that, where goods and services are bundled together, investment managers must only use dealing commission to pay for the research element. In other words, the research must deaggregated from the remainder of the goods and services.

The FCA believes that arranging access to corporate management does not amount to research and, therefore, must not be paid for with dealing commission. The "arrangement" service does not provide "any analysis or insight, or reach meaningful conclusions", according to the FCA, and it is hardly likely to contain original thought either. However, the FCA does state that it is not barring completely the arranging of corporate access or investment managers paying for it, so long as it is carried on within the boundaries of its wider market conduct regime (including any market abuse rules). The FCA is also not decreeing how the cost of corporate access is otherwise allocated between investment managers and their customers, so long as they comply with the any other applicable rules in the FCA Handbook. It is simply stating that dealing commission must not be used to pay for it.

INTERACTION WITH MIFID II

The proposals in the consultation paper do not alter the substance of the current rules, they merely clarify the position further. Therefore, as such they are already in compliance with the UK's MiFID regime. Since MiFID II is, as yet, not finalised, and is unlikely to come in before 2016, the FCA believes it is worth bringing in these proposals now, so as to provide the industry with added clarity ahead of any reforms to come.

GOING FORWARD

The FCA wishes to have an open debate with the industry and other stakeholders on the reform of dealing commission, since it believes there are still inherent flaws in the system. It views this consultation paper as a starting point for further, wider reforms and will welcome input and general comments from across the industry, alongside formal responses to the paper. These could include whether other rules or guidance would be helpful to improve the use of dealing commission and the existing provision of bundled brokerage arrangements in the longer term. The consultation also fits in well with the FCA's renewed focus on wholesale conduct as part of its remit to promote market integrity and effective competition. It should be read in conjunction with recent speeches by David Lawton and Martin Wheatley on market integrity and regulation as well as other materials published by the FCA this autumn to give it its true context.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our financial institutions practice group:

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