TETRACTYS PARTNERS BRIEFING NOTE FCA CP13/17 – USE OF DEALING COMMISSION

BRIEFING 04, DECEMBER 2013

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INTRODUCTION

Rules on the use of dealing commission were created by the then Financial Services authority in the middle of the last decade. Following its findings from visits to a number of investment managers of various descriptions, the FCA considers that a number of firms are not exercising proper judgment about what services may be paid for via dealing commission and are thus subsidising their own running costs from the pockets of their clients.

On this basis the FCA has deemed it necessary to create more (and hopefully clearer) guidance on the acceptable use of dealing commissions on which it is consulting in this paper, CP13/17.

This matter affects UCITS managers, managers authorised under MiFID and those managers that will be managers under the new AIFMD, so they should read this paper carefully as it could have cost implications for them, depending on how they have historically interpreted the dealing commission rules.

FCA FOCUS AND CONCERNS

When the original dealing commission rules (found at COBS 11.6) were introduced, the regulator was keen to give investors clarity over the use of “dealing commission” – the excess of commissions paid to trade securities over the actual cost of trading those securities, as this could be seen to be in conflict with the best execution obligation.

These excess dealing commissions were often used to pay for investment research or ancillary services such as price feeds or Bloomberg terminals. As these costs came out of the funds being managed on behalf of the client, this represented a conflict of interest as the client was effectively subsidising the normal business costs of the investment manager (a conflict of interest) with no transparency around the extent of such payments and what they were used to purchase.

As well as introducing disclosure requirements around the extent, nature and use of such dealing commission purchases, the regulator also introduced a

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series of tests to be applied wherever it was claimed that the services constituted "research" – namely that the service:

- was capable of adding value to the investment or trading decisions by providing new insights that inform the investment manager when making investment decisions for clients;
- whatever form its output took, it represented original thought, in the critical and careful consideration and assessment of new and existing facts, and did not merely repeat or repackage what has been presented before;
- had intellectual rigour, and did not merely state what is commonplace or self-evident; and
- involved analysis or manipulation of data to reach meaningful conclusions.

The Guidance made it clear that price feeds could not be paid for via dealing commissions (as they do not meet the criteria above) and it also provided a (non-exhaustive) list of items which do not constitute permitted goods and services (COBS 11.6.7G and 11.6.8G).

The FCA's aim in consulting on these new proposals is to ensure that firms are acting consistently with the original intention of the dealing commission rules. The FCA proposes to change the Rules in the following ways:

- to define corporate access and add it to the list of items that cannot be paid for from dealing commission;
- to amend the relevant evidential provisions such that charging goods and services to dealing commission that do not meet the criteria will tend to establish non-compliance with dealing commission rules. This should make the compliance boundary clearer by presuming a breach of the rules if the cumulative criteria are not met;
- to give guidance on how investment managers should approach judgements around their duty to act in the customer's best interests and passing charges to the customer through dealing commission for goods and services that meet the relevant exemption; and
- to clarify the position around mixed-use assessments where 'substantive' research is provided with other goods/services that cannot be funded through dealing commissions.

These proposals do not add further regulatory burden, rather they aim to provide clarity and consistency. However, depending on how firms have made their assessments on what can and cannot be charged to dealing commission

KEY MESSAGES AND NEXT STEPS

The key message from the FCA is that not all firms are exercising appropriate judgment in this area which creates a conflict of interest with clients. Clearly if a firm and its management have not identified or managed this conflict well, it might be considered a poor reflection on its culture (a particular FCA focus at the moment) and its controls.

Firms should consider conducting a review of the services that are purchased via dealing commission arrangements against the proposals set out in the CP.

While this is currently only a Consultation Paper, it is clear that the FCA believes there is a strong case for the new rules. The FCA wants to ensure firms are following the original intent of the Rules. The proposals in the CP itself are not "controversial" and add clarity, so it is unlikely there will be any major change before the proposals are finally enshrined in the FCA Rulebook.

An early review will help firms identify the extent to which these changes will affect them, and the level of expenditure on services they will now need to pay for from their own income, rather than pass the costs on to the fund. This will help identify any cash flow issues (which might be important for smaller firms) and enable a controlled and structured transition to the new regime.

HOW TETRACTYS CAN HELP YOU

Tetractys can help to review existing arrangements for managing dealing commission and the way in which it is spent against the new requirements and advise on any changes needed in order to comply with the proposed new rules. Starting to address these issues now will help firms identify any potential cost issues that these rule changes might mean for them, based on their current practice. The impact of the necessary changes can then be spread over time prior to the implementation of the new rules. For a no-obligation discussion, please call Gary Pitts on 07795 830 636 or email gary.pitts@tetractyspartners.com.