Investment Management Association

ima

25 February 2014

Adam Wreglesworth
Financial Conduct Authority

By email only to cp13-17@fca.org.uk

**Response to FCA Consultation CP13/17**

Dear Sirs,

Thank you for providing us with an opportunity to respond to the above-mentioned consultation. The IMA represents over 200 asset management firms carrying out business in and from the United Kingdom. Nearly all are regulated in the UK. Our most recent statistics indicate that our members manage around £1.9 trillion of equities from the UK, and therefore the subject matter of your consultation is highly relevant to our membership base.

Our members acknowledge the importance of ensuring that clients are confident that managers are acting in their best interest when they purchase research. Amongst other things, this demands that the oversight of the procurement process ensures that dealing commission is only used where allowable services are purchased.

As you are aware, the IMA has commented more widely on this subject in our report "The Use of Dealing Commission for the Purchase of Investment Research" which reviews the benefits and challenges of the current model and looks beyond the UK rules to consider the impact of change. Our wider report discusses key concepts such as governance, budget setting and conflict management, but our comments in this paper are limited to the matters you specifically propose to change.

## In summary

We object to the removal of the "reasonable grounds" provision in COBS 11.6.3R(2). It is disproportionate in light of the proposed tightening of the research definition, the nature of sell-side supply and possible revisions arising from MiFID II.

Given your policy to tighten the research definition, we question whether "conclusions" is still the best term and ask for clarity about the permitted status of some research services, in particular, expert networks.

We ask for confirmation about our analysis of unrewarded services received in an unpriced bundled supply. We suggest the wording of 11.6.8A G(2) could be improved in this regard.

We ask for guidance in several areas, in particular, about the international application of COBS.

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We respond under three headings:

A. Issues about scope

B. Issues about valuation

C. Issues about international operations

## A. Issues about scope

### *A departure from historic high-level, purposive definition of research*

We note that the FCA in several places states that the purpose of the consultation is to clarify the existing rules. As a matter of textual interpretation, the proposed changes may allow greater objectivity in determining what does and does not constitute 'permitted' research, we do not accept that the proposals are a mere clarification.

The existing conceptual framework for COBS 11.6 was confirmed in PS05/9 by FSA:

> *"The responses indicated that we [FSA] are correct to apply high-level, purposive rules that leave the investment manager to make reasonable judgements on whether it is appropriate to pay for execution and research services with commission within this framework. We consider that investment managers are best placed to make these decisions, taking into account the individual circumstances of the firm and the use they make of those goods and services."*

By removing the reasonable grounds reference in 11.6.3R(2), the proposed changes mark a departure from the existing paradigm of reasonable judgement by a manager and replace it by regulatory prescription.

As proposed in the CP, what qualifies as substantive research is now more directly identified by 11.6.5E(1) due to the removal of the reasonable grounds provision in 5E. We have noted your description in the CP at 2.35 2$^{nd}$ tiret of the proposed changes made to COBS 11.6.4E and 5E and as we understand it, your intent is that it is possible that there could be substantive research which does not meet the four tests and that some good or service could meet the four tests but which might nonetheless not be substantive research.

However, as such, your drafting does not take this direct route of stating that the evidential tests establishes compliance with 11.6.3R(2), and instead attaches the evidential tests to the entire use of dealing commission rule (11.6.3R), which itself is proposed to be altered. This has always been the approach in your rules but in light of the deletion of the reasonable grounds test in the definition of research in 11.6.5E, the proposed alterations to 11.6.3R are receiving a lot of focus.

The reason for the removal of the reasonable grounds provision in 11.6.3R(2) is not discernible from a reading of CP13/17 or otherwise. We do not consider that supervisors will necessarily approach firms as if the reasonable grounds provisions were still there nor, more importantly, should it be assumed the Courts would do so, in light of the legislative history showing a deletion (even if it occurs without explanation).

The deletion of the reasonable grounds provision in 11.6.3R will not assist with compliance nor has FCA shown such a major change to be in the interests of clients. Whilst IMA can understand FCA's concern to introduce a tighter definition of substantive research at

11.6.5E(1) without needing to refer to reasonable grounds[1], the removal at 11.6.3R is not made out and appears to ignore the reality of the market for the purchase of research.

Investment managers directing themselves honestly, fairly and professionally should be expected to have reasonable grounds for believing that the research they purchase is substantive research, but we do not see why they should be held to a strict liability standard. Given the many goods and services that could potentially constitute research under 11.6.3R, and the difficulty of drawing a bright-line between what is permitted research and other goods and services that fall outside the exemption, such a strict liability standard is particularly inappropriate.

The IMA's research report recognises the need for a more developed taxonomy in research services. In the absence of industry standards for labelling or a common syntax of services, the FCA appears to be leaving all the effort to the buy-side in this complicated and untested area. The cost of this should not be under-estimated.

We strongly believe the retention of the reasonable grounds provision at 11.6.3R is necessary *at this time*.

The IMA hopes that the sell-side will co-operate in developing a richer, and more consistently labelled, taxonomy of research and advisory services. This should enable asset managers, especially those running smaller funds and mandates, to determine more cost-effectively whether any good or service met the requirements of 11.6.5E(1)(a) to (d).

We note how in our preparation of this reply some have been reading 11.6.5E(3) as an attempt to reverse the burden of proof; the sensitivity about this is understandable and comes about as much by the removal of the reasonable grounds text in 11.6.3R(2) as it is about the drafting of 11.6.5E(3).

In due course, with a greater degree of clear labelling or even kite-marking, then it may be more proportionate to consider whether the reasonable grounds test could be removed. At the present time, this removal is disproportionate in the absence of both discernible activity from suppliers to better describe their services and the complexity of the determination.

Our view is strengthened by the knowledge that MiFID II will require us all to consider again the extent of permitted services. It would be preferable to review 11.6.3's use of reasonable grounds, once the direction of MiFID II is clearer. Any work on delegated acts under Article 24 (or Article 16 guidelines from ESMA) is highly likely to be well within a two year timeframe.

We acknowledge that, as now and as proposed, 11.6.5E(2) will mean that whenever a manager uses dealing commission to buy substantive research, then that would automatically tend also to evidence the requirement that the good or service "will reasonably assist the investment manager in the provision of its services to its customers on whose behalf the orders are being executed and does not, and is not likely to, impair compliance with the duty of the investment manager to act in the best interests of its customers" as 11.6.3R(2)(b) states. An investment manager would continue not to need to demonstrate that it had reasonable grounds to be satisfied this was so and FCA would have an evidential burden to overcome. Whilst this reduces some compliance costs, in our

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opinion, the greater compliance burden lies in evidencing that everything which is rewarded meets the four tests in light of the proposed alteration to 11.6.3R.

Finally, the need to demonstrate that a service or good satisfies all four of the evidential tests will increase the cost of enquiry in relation to any service offering from a full-service broker as well as on-going compliance costs. This is a reflection of the unpriced bundled supply from investment brokers in the research market. We consider the references in paragraphs 8 and 9 of Annex 1 ignore the increased compliance costs and that these are exacerbated by removing the reasonable grounds provision.

It follows that we would propose that if there is to be change, COBS 11.6.3R(2) should read as follows:

*(2) This prohibition does not apply if the investment manager has reasonable grounds to be satisfied that the relevant good or services received in return for the charges:*
*(a) (i) is directly related to the execution of trades on behalf of the investment manager's customers; or*
*(ii) amounts to the provision of substantive research; and*
*(b) will reasonably assist the investment manager in the provision of its services to its customers on whose behalf the orders are being executed and does not, and is not likely to, impair compliance with the duty of the investment manager to act in the best interests of its customers.*

### *Meaningful conclusions*

Many want to be reassured that the new reference to presenting to an investment manager a "meaningful conclusion" should still permit a wide range of research outputs and that a conclusion can be meaningful without requiring the manager to follow any conclusion or weight it consistently with the researcher's recommendation.

The text of the CP at 2.35, 2nd tiret has again caused concern in this regard:

> *".... 'substantive' research and indicating that meaningful conclusions must be presented to the investment manager and it is not intended to mean any good or service that leads to the manager then drawing their own inferences."*

This appears to be a very wide assertion, and we hope it is not quite what FCA meant. A conclusion should continue to be regarded as meaningful even if the investment manager's decision does not follow the direction or time frame that the researcher might have explicitly or implicitly recommended. FCA's statement opens up concerns as to what could be meaningful and how could a firm demonstrate that since it suggests that whenever a manager draws its own inferences, the research will not be substantive. We would have expected FCA to have been addressing research that did not have a meaningful conclusion not whether the manager draws its own inferences. It would be helpful to clarify that this CP text is not providing an indication as to how FCA will read its own rules.

In this regard, the new conceptual framework used by the FCA may be better supported by referring to "meaningful findings or insights" so as to avoid a word that appears to end the research process rather than identify completion of a substantive phase of that process.

A related concern revolves around the question of evidencing the conclusion's meaningfulness, which is regarded as particularly challenging when receiving research in non-written form, e.g. via face-time with research analysts, attendance at research

conferences or the use of expert networks. This is especially so as FCA's language does seem to be directed at written material.

FCA will have noted the SEC's consideration in release No. 54165 (July 18, 2006) at page 35 of the consequences of moving to a more defined requirement to present research (in an analogous situation of market data services):

> *"Additionally, we believe that excluding market data from the safe harbor could become meaningless if it encouraged purveyors of this information to simply add some minimal or inconsequential functionality to the data to bring it within the safe harbor."*

We expect that the market will now move to add a meaningful conclusion to a range of outputs. As matters stand, managers will now be re-considering the status of a range of services and we think those service providers will themselves be altering their behaviour. By way of example only:

i) Primary Research – will some or all forms of primary research meet the standards required in 11.6.5E or will they lack a meaningful conclusion? This will include channel checking, data gathering and fundamental surveys, which may now have a conclusion added.

ii) Consultations - this may not be clear cut. Some forms of consultations will qualify, provided the consultant can produce a meaningful conclusion and not just guidance on technical matters.

iii) Expert Networks - whilst the larger expert networks facilitate primary research such as surveys and consultations, their intermediation will cause procedural changes in the near future so as to allow for the research to qualify under 11.6.5E. For example, a telephone consultation might now incorporate a 'meaningful conclusion' from the expert to ensure compliance with the rules. Evidencing such compliance is another concern.

iv) Business Intelligence - many of these providers assimilate publicly available information to produce a unique observation from which the recipient is meant to draw their own conclusion. This may change in the future with the provider extending their reports to include a meaningful conclusion (which may not be followed) in order to comply with the evidential standards.

v) Enhanced Primary Research - it is not unreasonable to conclude that the amended rules will result in procedural or formative changes amongst research providers in order for their product to qualify as commissionable research. The unintended consequence of the rule changes therefore, will be more costly eligible research because of the extra administrative steps necessary for it to meet the qualification threshold.

Given the comments in the CP, we would invite the FCA to describe its views on the above and particularly on expert networks and the legitimacy of paying them for meaningful insights. This appears (globally) to be a developing area and provides investment managers with access to primary market research via consultations with industry and subject matter experts. Consultations between expert network clients and experts may take many forms including face to face meetings, emails and phone calls and provide investment managers with information, analysis, market expertise or industry expertise for use in formulating investment views and in making investment decisions. Recent SEC concerns about one or two so-called experts is about misuse of insider information, which naturally we do not condone – but that does not mean that expert networks properly used should not be seen as sources of substantive research. Our point is that an investment manager should be

permitted to use such inputs to form a mosaic from which ultimately decisions to deal or hold can be reached.

In the same way it would be helpful to know that the FCA agrees that the delivery of tailored advice and assistance by a sales person at an investment bank in relation to published research should continue to fall within the permitted areas of expenditure.

We will explore whether a standing group on permitted research should be formed and meet quarterly to provide early warnings and industry engagement on services that are being considered for payment through dealing commission. Should FCA wish to chair such a group, they would be welcome; alternatively IMA would invite FCA as an observer.

## B. Issues about valuation

### *Payment rather than receipt is the issue*

Given FCA's comments about paying only for the allowable services, a question which follows from the proposed changes is whether it is the receipt of disallowed services as such or payment for disallowed services which breaches 11.6.3R(1) – the proposed text of which is below:

*1) An investment manager must not accept any good or service in addition to the execution of its customer orders if it:*

*(a) executes its customer orders through a broker or another person;*
*(b) passes on the broker's or other person's charges to its customers; and*
*(c) is offered that good or service in return for the charges referred to in (b).*

We consider that it is not the receipt of disallowed services as such but payment for them with dealing commission which breaches 11.6.3R(1). The rule states a manager must "not accept" any good or service if conditions (a) to (c) are met. The combination of (b) and (c) also creates the requirement that the manager must not be offered any good or service in return for the broker's charges that are passed on to customers. Given that the services from full-service brokers are provided on an unpriced basis, whether the manager "passes on" a charge depends upon whether, when determining the quantum of reward to be paid to a broker, the manager place a value or cost upon some good or service, or aspect or portion thereof, which does not meet the four requirements of 11.6.5E(1).

Therefore, in a market in which managers are price-setters and not price-takers, a manager is not permitted to pay for (as in reward) a disallowed service; whether the manager actually receives any disallowed service is not the test.

This is critical. To date, it does not appear that mixed-usage methodologies have been used for unpriced services such as research conferences. With a priced service, such as for market data research services, the invoice can be split and so it can be clearly said that the manager only "passes on" the component of the charge that relates to the allowed service. But the introduction of an explicit ban on "any" corporate access service now introduces the possibility that a large part of the market will receive services, some of which can and some of which cannot be paid for from dealing commission.

The proposed 11.6.8A G(2) states that the manager should disaggregate any such good or service "to ensure that it only accepts the substantive research element under COBS 11.6.3R(1)". As noted above, we do not think this language captures what will occur with unpriced services and is too influenced by the (more straightforward) application of mixed-usage methodologies to services rendered with priced invoices.

This becomes especially important given the proposal to make corporate access services a disallowed service. The IMA does not oppose the introduction of 11.6.8G(4A) but comments on the guidance that the FCA gives about valuation and the international aspects to provide greater operational certainty to firms if 4A is introduced.

In the view of the IMA, the banning of corporate access services leaves managers with three options:

1. No longer to accept any corporate access services from such firms;
2. Not to pay for corporate access services and, of course, not to reward them through the use of dealing commission; and,
3. To pay for corporate access explicitly and fully, but not through the use of dealing commission.

The dramatic change of option 1 should not be caused by the FCA changing the rules; the IMA considers it is probably not, but 11.6.8A G(2) could be better worded (at least by replacing the term "accepted") given the importance of engagement and stewardship.

In option 2, it could be said that the "service received" from the broker "comprises" both an allowed service of research and also the disallowed service of corporate access. The IMA proposes that 11.6.8A G(2) should make it clear that in such a situation:

a) The manager must ensure that it only rewards the provision of the allowable service and meets 11.6.8A G(1)(b) – acting honestly when dictating a price; and,
b) The manager must ensure that any inducement disclosure under COBS 2.3.1R(2)(b) is capable of encompassing the receipt of corporate access services by managers from a broker without payment to a broker.

Both rule sections, COBS 11.6 and COBS 2.3 also make clear the need to act in the best interest of the clients.

In option 3, if the manager pays a commercial rate from its own financial resources, then point a) of option 2 still applies, but there will not be an inducement disclosure.

Accordingly, we would welcome the FCA's confirmation of our understanding of its rules for two reasons:

1. We consider the reference to mixed-usage assessment in paragraph 2.30 of the CP text to be either unnecessary or to be a test which currently under 11.6.8A G is designed to deal with priced services. Whether characterised as mixed-usage or not, the obligation on the manager is the same for unpriced services – the research portion should be valued without influence from extraneous factors, such as whether corporate access services are used.
2. Reference to the need for an inducement disclosure where corporate access is not paid for seems to be an important omission in the references in paragraph 1.21 of the CP text. We do agree that the duties mentioned in that paragraph are also relevant. Specifically:
   - the duty to manage conflicts (and the wider duties of SYSC 10.1);
   - the client's best interests rule (COBS 2.1.1R (1)); and,
   - the clear communication rule (COBS 4.2.1R(1)).

We record the concerns expressed by some that it appears odd that brokers will give a service for free and that FCA will expect a reduction in research expenditure as firms no longer pay for corporate access from dealing commission and that absent a reduction it will

be suggested that it is still being rewarded. FCA's confirmation of IMA's understanding of the options open to investment managers and the regulatory consequences will help in limiting defensive over-compliance, such as by paying (from P&L not by using client commissions) for corporate access that previously was not paid for and which will ultimately only add to costs for clients.

### *Mixed-usage methodologies – COBS 11.6.8A G(2)*

There is a great deal of concern over mixed-usage methodologies. Some firms do not use mixed-usage methodologies within their regulatory risk appetite but rather choose to pay for what are (commonly) market data services bundled with data-based research exclusively from their own financial resources.

Our view is that "disaggregation" does not require an evaluation of the monetary value of each part but an identification of which components are qualifying and which not. Then, having isolated the qualifying components, their price or cost must be assessed.

We think the clarification given in the guidance is uncontroversial as a technical expression of the regulation, but as it is now made explicit for the first time we think this will only lead to a greater number of firms not using mixed-usage methodologies.

Nevertheless, because it will remain legitimate under the proposed changes to the rules, some firms will seek to split the cost of invoices they receive so as to apportion the cost appropriately as between the manager and clients; the FCA rules state that is done by assessing the value of the research component. In this regard, whilst an investment manager may be able to associate a value to the allowable services, does FCA consider the comments by the SEC also indicate other methods of attributing cost which FCA would find acceptable?

*"In allocating costs for a particular product or service, a money manager should make a good faith, fact-based analysis of how it and its employees use the product or service. It may be reasonable for the money manager to infer relative costs from relative benefits to the firm or its clients. Relevant factors might include, for example, the amount of time the product or service is used for eligible purposes versus non-eligible purposes, the relative utility (measured by objective metrics) to the firm of the eligible versus non-eligible uses, and the extent to which the product is redundant with other products employed by the firm for the same purpose."*

We acknowledge that if an asset manager is to invoice its clients for something then it ought to have a high-level of confidence that the cost recharged to clients is appropriate. Nevertheless, several members inform us of their concerns as to how to construct such a methodology. We assume that, in the absence further guidance, a wide range of views in the industry will remain as to what fraction of such bundled services could be paid for by dealing commission.

There may be legal difficulties in the IMA assisting further with this as the reality is that for many firms this is a discussion about particular services received from one or two suppliers and those suppliers are common to a very wide part of the industry. It does not assist the industry to have a wide range of approaches, so any guidance as requested above would be welcome.

### *Further comments about COBS 11.6.8A G:*

The guidance at COBS 11.6.8A G(1)(a) is essentially uncontroversial but we would be grateful for clarification that if there are different tax implications between the payment by the asset manager and the recharge to the client that those tax effects are not seen as passing on a greater cost. For example:

> Where VAT is already applied by a UK provider, for example when a report is invoiced at £20,000 plus VAT, the gross cost of £24,000 is charged to the CSA pot (and thus to clients).
>
> Where an identical report is supplied by a non-UK provider, the investment manager has to account to HMRC by reverse charge. In this case, £20,000 is debited to the CSA and then an additional £4,000 is debited for the payment that is made by the investment manager to HMRC.
>
> Of course, in either case, to the extent any VAT can be recovered from HMRC, then that recovery is credited to the CSA.

We would welcome specific confirmation that this treatment of the reverse charge and VAT complies with the proposed guidance at 11.6.8A G

We think the aim of the rule is ensuring that the investment manager cannot charge more than it itself was charged, albeit that the cost to the consumer may have to be grossed up because of the imposition of some tax.

## C. The international dimension

In PS05/9, the FSA responded to requests for greater clarity about the territorial scope of its rules. Your response was as follows:

*"Our rules will apply to investment management activity carried out in the UK. There is no difference between the territorial scope of these rules and the territorial scope of the rest of COB."*

Assuming the rule changes are made, the concerns over territorial scope are increased given the now wider distinction between the FCA and SEC rules over corporate access and the tighter definition of research. At an international investment manager, for example, orders made from the UK on behalf of UK clients to buy US shares can be aggregated with orders made on behalf of US clients by a US affiliate of the UK manager. This would aim to achieve economies of scale and to treat orders from different clients equitably. If the US affiliate directed an order to a US broker which executed the order on a bundled basis, then the UK manager would have to ask whether the UK client had consequently borne a "research commission" cost and whether the UK manager received a prohibited research service.

Alternatively, if the investment manager did not receive the prohibited service, but still paid the US bundled rate, then the UK client could be paying more than the US client for the execution; though it may be that overall it is still cheaper for the UK client to be so aggregated.

The potential negative impact on how UK client orders are traded with other international orders could reduce the competitiveness of the UK as a centre from which many international investment managers organise their equity trading.

Firms would be assisted if the FCA could provide guidance as to when the COBS rules might engage, especially given the FCA's stated position of reading the rules purposively. We think there are at least four scenarios where FCA could assist industry:

1. All discretion is exercised by a UK authorised investment manager for a client directly contracted to it and therefore all decisions to buy or sell a security are made by the UK authorised firm (whether the individuals making that decision are under a contract for services or employment contract). COBS rules apply wherever any order is placed or trade executed.
2. Discretion over a specified portion of the portfolio is wholly delegated[2] **to** the UK manager **by** a manager outside the jurisdiction. Does COBS 11.6 apply to the activity of the UK manager?
3. Discretion over a specified portion of the portfolio is wholly delegated **by** the UK manager **to** a manager outside the jurisdiction. If such a manager outside the UK makes an investment decision to buy or sell a security, then COBS 11.6 would not apply to that manager. As the UK manager will have not chosen where or how to place the order (so it is not executing through the broker), it would appear not to have accepted any disallowed service in breach of COBS 11.6.3.
4. Trading and execution are centralised in a UK-regulated firm within a group but orders (investment decisions to buy or sell securities) are generated by investment management companies not regulated by the FCA. They may be part of the group to which the UK firm belongs but they would not have to be. In this regard, the centralised trading desks are not prevented from directing orders on a bundled basis for execution in the UK or other jurisdictions, and COBS 11.6 does not apply as the UK regulated firm is not in this capacity managing investments.

More specifically FCA should provide guidance as to the interaction between jurisdiction founded on:

a. the activity of making decisions to deal in financial instruments on behalf of a client; and
b. the execution of the order or (more commonly for investment managers) the placing of an order with a broker for execution that results from a decision to deal.

Is it the case that it is a. which engages COBS 11.6?

We think FCA should be able to comment upon the jurisdictional reach of COBS 11.6 without needing to alter wider policy on the existing perimeter of COBS. The use of dealing commission is a global activity. We would welcome the opportunity to assist FCA in working through this complicated area and in consultation with the wider industry and global groups. For the time being, even if only in the body of the Policy Statement, it would be very helpful if FCA could give some directional guidance whilst providing a transitional period for global firms to consider their position.

In conclusion, we would welcome further discussion if this assists the FCA.

Yours faithfully

Guy Sears
Director, Risk, Compliance and Legal

[2] Which throughout the scenarios would include arrangements under which an overseas manager in the same group as the UK manager operates under inter-company agreements to provide services to the UK manager.