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JUST THE BEGINNING: THE FCA PROPOSES CHANGES TO THE DEALING COMMISSION REGIME

On 25 November 2013, the Financial Conduct Authority ("FCA") published CP13/17 on proposed changes to the dealing commission rules. The FCA's intent is to clarify when asset managers can use dealing commission to pay for goods and services. The changes are intended to be the first step in a long-term effort to overhaul the dealing commission regime, in order to better serve the clients of asset managers.

This new approach to the treatment of dealing commission will be of interest to asset managers, institutional investors and prime brokers.

EXECUTIVE SUMMARY

The changes set out in CP13/17 will amend the dealing commission rules (contained in the FCA's Conduct of Business Sourcebook 11.6 ("COBS 11.6")) in the following ways:

- Clarify the criteria which enable asset managers to determine if research can be paid for with dealing commission;
- Define "corporate access" and set out that it cannot be paid for with dealing commission; and
- Provide guidance on mixed-used assessments where asset managers purchase bundled services which include both execution and research services that can be paid for with dealing commission and those other services that cannot. This is to ensure that asset managers use dealing commission only to pay for execution services and research and not other bundled goods or services.

The FCA hopes that these rule changes will lead to greater market integrity and ensure that asset managers act in the best interests of their clients. However, there is a risk that this may increase the overall costs of asset managers and cut off the ability of asset managers to engage with the officers and directors of corporations.

THE CURRENT REGIME

COBS 11.6 allows the use of dealing commission only to pay for execution and research services and, in respect of such services, certain criteria must be met. The fundamental principle underpinning COBS 11.6 is that asset managers cannot pay for services with dealing commission unless it would be in the best interests of their clients to do so.

The regime is designed to ensure that when making decisions on paying for services with dealing commission the services are linked to clients' investments. Additionally, asset managers must disclose dealing commission arrangements to their clients.

THE PROPOSED CHANGES

The dealing commission regime was originally introduced in 2006 to limit the ability of asset managers to pass their own management costs onto their fund clients via the use of dealing commission payments. However, concerns arose regarding the efficacy of COBS 11.6, particularly that the rules were drafted in such a way as to be interpreted in a manner inconsistent with strictly limiting dealing commission payments to execution and research services. Given that over GBP 3 billion was generated in dealing commission in 2012, with around half this figure being spent on research, this has become an area of regulatory focus.

The FCA believes that not all dealing commission spent on research (i) offers good value to clients, (ii) would have been spent if the asset managers had to pay for the research using their own funds and (iii) would fall within the bounds of what the FCA considers to be research for the purposes of COBS 11.6.

Clarifying the Use of Dealing Commission to Pay for Research. CP13/17 specifically addresses the ability to purchase research using dealing commission under COBS 11.6. Under the current rules, an asset manager must be "reasonably satisfied" that the research being purchased meets certain cumulative requirements set out in COBS 11.6. The changes proposed in CP13/17 narrow the language used in COBS 11.6 and remove the discretionary ("reasonably satisfied") element on the part of asset managers. Using dealing commission to purchase research goods or services that do not meet the new clarified rules would establish a breach of COBS 11.6. It is the FCA's expectation that these rule changes will clearly establish the perimeters within which asset managers can purchase research using dealing commission.

The FCA's proposed new rules will also require that research purchased using dealing commission must be "substantive"; as such, the research must present meaningful conclusions to the asset manager rather than simply providing information from which the asset manager can draw its own conclusions. This will exclude using dealing commission to purchase market data services, translation services, access to IPOs and corporate access.

Corporate Access. Corporate access was identified as one of the key services that asset managers were paying for with dealing commission. The FCA's own findings note that asset managers consider corporate access to be one of the most important services provided by prime brokers. In spite of this, the FCA maintains that corporate access does not, in itself, amount to research. The FCA's concern around this area is that paying for corporate access via dealing commission may encourage assets managers to direct their business to those prime brokers who provide access rather than the brokers who provide the best terms of execution for their clients.

To prevent the continued use of dealing commission to pay for corporate access, the FCA will provide a definition of "corporate access services"[1] and add corporate access to the list of services that cannot be paid for using dealing commission.

Guidance on Mixed-Used Assessments. To assist asset managers who are paying for several different types of goods and services as part of a bundle, the FCA will provide new guidance to enable asset managers to determine the extent to which the services can be paid for with dealing commission. In essence this guidance is intended to

1 FCA proposed definition: *"Corporate access services – a service of arranging or bringing about contact between an investment manager and an issuer or potential issuer".*

encourage the following behavioural characteristics. When dealing commission is used, asset managers should:

- Ensure that they are acting in the best interests of their clients;
- Wherever possible, identify the cost of those goods and services paid for with dealing commission and the dealing commission charge should not be greater than this amount; and
- Negotiate what is paid for with dealing commission—the asset manager should always act in the best interests of its clients.

THE FUTURE

CP13/17 notes that these changes to the dealing commission regime are potentially just the first step in wider reforms as the FCA looks to better protect the interests of asset managers' clients. The FCA is of the opinion that the proposed changes to the dealing commission regime will not be enough to address conflicts of interest that arise through the use of dealing commission, both by asset managers and prime brokers. In addition, the FCA is proposing that an EU-wide debate (including the unbundling of goods and services purchased from prime brokers) is had on improving the transparency and efficiency of asset management prior to the implementation of MiFID II. In light of this, Jones Day considers that these will not be the last changes to the dealing commission regime.

KEY POINTS TO BE CONSIDERED

- Although the FCA's proposed amendments will set out a more restrictive dealing commission regime, the FCA considers that this restrictive regime is already in force and the amendments simply clarify this.
- Asset managers and prime brokers should anticipate greater regulatory scrutiny of their use of dealing commission.
- As dealing commission cannot be used, the approach taken to payments for corporate access is likely to be a major challenge for many asset managers.
- Asset managers should take this opportunity to review existing conflicts policies and their past use of dealing commissions.
- The FCA has requested that interested parties respond to CP13/17 by 25 February 2014.

ABOUT JONES DAY'S FINANCIAL INSTITUTIONS REGULATION PRACTICE

Jones Day's Financial Institutions Regulation practice advises numerous banks, financial institutions and asset managers around the world. Our clients rely on us to assist them in respect of complex transactional matters (including fund formation and structuring), emerging legal proposals and trends, regulatory compliance, potential enforcement proceedings, legislative initiatives and other areas of strategic risk.

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