25 February 2014

Adam Wreglesworth
Wholesale Conduct Policy & Client Assets
Markets Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Re: Consultation on the Use of Dealing Commission Rules (CP13/17)

Dear Sir or Madam:

ICI Global¹ is writing to respond to the Financial Conduct Authority’s (FCA) consultation on the use of dealing commission rules (Consultation).² We support the FCA’s efforts to ensure that investment managers put customers’ best interests first and seek to control costs to clients to the extent possible. We are therefore pleased that the FCA has determined to issue the Consultation to better understand the existing dealing commission regime and the ramifications of changes to the regime proposed in the Consultation, as well as the effects of more fundamental changes. As many ICI Global members operate global businesses, with asset management operations in the United Kingdom (UK) among other jurisdictions, the Consultation raises a number of significant issues for our members.

As an initial matter, while the FCA states that the purpose of the Consultation is to clarify existing rules, we strongly believe that the proposals go beyond mere clarification and mark a significant shift in the FCA’s interpretation of these issues. Implementing these changes, as described in more detail below, may for some firms require a substantial reworking of their trading and research operations and systems, as well as their policies and procedures relating to dealing commission. We respectfully disagree, therefore, with the FCA’s perception that the proposed revisions do not restrict activities any further than current rules and that firms will therefore not incur any material incremental costs. Rather, we believe that the costs of implementation and compliance may be significant. We

¹ ICI Global is a global fund trade organization based in London; members include regulated U.S. and non-U.S. based funds publicly offered to investors in jurisdictions worldwide. ICI Global seeks to advance the common interests and to promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets of over $1.32 trillion.

recommend that the FCA further analyze the costs that will be incurred by investment managers to comply with the proposed changes and reconsider whether the perceived benefits of the proposed changes actually outweigh the costs to investment managers, and ultimately to investors. To the extent the FCA proceeds with its reforms, we urge the FCA to provide ample time for investment managers to comply with any new requirements or FCA positions.

I. Summary of Comments and Recommendations

Understanding of Global Regulations on Dealing Commission

- We believe that prior to implementing any reforms, the FCA must fully understand how jurisdictions around the world regulate the use of dealing commission, as well as how global investment management firms operate in today’s complex trading environment.

- We believe that IOSCO is well-placed to serve as a forum for facilitating the aggregation of information regarding the various regulatory regimes applicable to dealing commission; we encourage IOSCO to update its prior work on dealing commission arrangements.

Global Nature of Investment Management Industry

- We believe the FCA must take into consideration the global nature of the investment management industry as it considers reforms to the dealing commission regime; a marked regulatory divergence from established practices would pose significant challenges for investment managers.

- We believe significant reforms to the FCA’s dealing commission regime would make it difficult for investment management firms to maintain integrated research and trading operations.

Concerns Regarding Proposed Changes and Potential Consequences

- *Impact on Small and Medium-Sized Investment Managers:* We are concerned that the proposed change to corporate access will reduce access to issuers, particularly for small and medium-sized investment managers; we recommend that the FCA gather data and undertake further analysis of this issue.

- *Corporate Access – Incidental Assistance:* We recommend that the FCA clarify how the dealing commission and inducements rules apply to situations where a broker may provide “incidental assistance” in arranging corporate access for an investment manager, e.g., access that is not paid for out of dealing commission and not recharged to clients.
• **Revisions to Definition and Interpretation of Research.** We believe the FCA should not proceed with proposed changes to the research exemption eliminating the “reasonable grounds” standard under which investment managers currently operate. To the extent the FCA proceeds with revisions, it should: (1) clarify that application of the criteria to determine what is “substantive research” is subjective; (2) explicitly include any items that are not permitted to be treated as exempt research on the list of items that are not exempt for clarity; and (3) confirm that investment managers can use a “proportional approach” to determine what is “substantive research.”

• **Necessity of Sell-Side Engagement.** We believe the FCA should not move forward with its proposals until, and unless, it also requires the sell-side to provide information to investment managers necessary to facilitate compliance with any changes.

• **Clarify Jurisdictional Application:** We recommend that the FCA give consideration to the jurisdictional application of its new regime, and unless and until there is international regulatory convergence, clarify that any new rules will only apply on a narrow basis so as to minimize any issues that may arise.

Considerations with Respect to Wider Reforms to the Dealing Commission Regime

• We recommend that the FCA consider refinements to the current dealing commission regime rather than adopting a more radical approach that further restricts or eliminates the use of dealing commission to purchase research.

• We recommend that the FCA issue a consultation requesting comment on any changes prior to taking further action with respect to dealing commission; in this manner, the FCA can consider the impact of reforms on investment managers.

II. **Understanding of Global Regulations on Dealing Commission – A Role for IOSCO**

The FCA is consulting on specific changes to its dealing commission regime and also more broadly requests feedback on the potential for wider reforms. We generally support the FCA’s efforts to review its regulations to ensure that the regulation of dealing commission is appropriate. We caution, however, that, prior to implementing any reforms with respect to dealing commission, the FCA must fully understand how jurisdictions around the world regulate the use of dealing commission, as well as how global investment management firms operate in today’s complex trading environment. As described below, due to the global nature of many investment managers and, therefore, their global research and trading operations, unilateral action by the FCA could have ramifications.

In this respect, we believe that the International Organization of Securities Commissions (IOSCO) is well-placed to serve as a forum for facilitating the aggregation of the regulatory regimes
applicable to dealing commission in IOSCO member jurisdictions (or a subset thereof). In fact, in 2007, at a time when a number of regulators were reviewing the regulation of dealing commission (referred to as “soft commission arrangements” by IOSCO), the IOSCO Technical Committee issued a report examining the regulation of dealing commission among SC5 member jurisdictions and identifying key issues (the “2007 Review”).\(^3\) The 2007 Review shows that, as of time of the review, leading jurisdictions had developed varying regulatory frameworks to address the challenges presented by dealing commission. The Technical Committee determined not to develop general principles for dealing commission in the 2007 Review.

The 2007 Review found certain elements of commonality among those jurisdictions that participated in the review\(^4\) – specifically, that with respect to the SC5 jurisdictions at that time, dealing commission arrangements must be consistent with a collective investment scheme (CIS) operator’s duty to act in the best interests of the CIS, and that all portfolio transactions must be subject to best execution requirements.\(^5\) The 2007 Review also showed, however, that despite these commonalities, jurisdictions have reasonably determined to address the challenges posed by the use of dealing commission through regulations that differ, at times markedly, in their detailed provisions.

For instance, there are differences in permissible goods and services and approaches to conflict management. The 2007 Review demonstrates that certain jurisdictions limit the goods and services that may be obtained with dealing commission, whereas others do not impose specific limitations and, further, the specific limitations that are imposed with respect to permissible goods and services vary among jurisdictions.\(^6\) Similarly, jurisdictions have developed varying means of regulating the potential conflicts presented by dealing commission. The 2007 Review recognizes that each jurisdiction must choose its own approach to regulating dealing commission, and that dealing commission can provide benefits to CIS investors, provided that conflicts are adequately addressed.\(^7\)

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\(^4\) Sixteen jurisdictions participated in the review, including the UK, the United States, Australia, France, Hong Kong, and Luxembourg.

\(^5\) Fiduciary principles require CIS operators to seek to obtain best execution for CIS portfolio securities transactions and limit CIS operators’ ability to use client assets for their own benefit. For example, the U.S. Securities and Exchange Commission (SEC) believes that an investment manager owes a fiduciary duty to clients to obtain best execution of their brokerage transactions and further believes that, to a significant degree, best execution is a qualitative concept. In seeking best execution, the SEC believes an investment adviser should consider the full range of a broker’s services, including the value of research provided, execution capability, commission rate, and certain other factors. See, e.g., Sec. Act Rel. No. 5250 (May 9, 1972) and Sec. Exch. Act Rel. No. 23170 (April 23, 1986).

\(^6\) Of particular relevance to this Consultation, corporate access is permitted in the United States, but the FCA is now proposing to disallow it.

\(^7\) 2007 Review at 8-9.
As the FCA considers implementing reforms to its dealing commission regime, including potentially fundamental changes to the ability to use dealing commission to pay for research at all or requiring unbundling, we believe it is imperative that the FCA consider how other jurisdictions regulate the use of dealing commission and the implications on global businesses resulting from a significant change to the UK regime. To assist in the FCA’s consideration, and for the collective benefit of regulators around the world as well as the global fund industry, we encourage IOSCO to undertake to update its prior work on dealing commission arrangements.

III. Global Nature of the Investment Management Industry

As the FCA considers reforms to the use of dealing commission, we ask that it take into consideration the global nature of today’s investment management industry and the ramifications of changes on the industry and its clients. As the FCA is aware, a significant proportion of large and medium-sized investment management firms today maintain operations in more than one jurisdiction, often including the UK, one of the world’s financial centers. For various reasons, such multi-jurisdictional firms may operate trading and research platforms that are fully integrated. Further, given the global nature of the investment management industry, there are many different combinations of the clients’ jurisdictions, the investment manager’s and its affiliates’ jurisdictions, and the trading jurisdiction. A marked regulatory divergence from established practices on dealing commissions by the FCA would pose significant challenges for investment managers that have a nexus to the UK.

As mentioned above, multi-jurisdictional firms may determine to operate trading and research platforms that are fully integrated for various reasons – including in order to take advantage of economies of scale, for personnel reasons, or operational alignment. These firms may choose to apply the same requirements on all of their trading and research operations for purposes of global consistency, regardless of whether a particular requirement applies in a given jurisdiction (so long as it is not incompatible with the applicable regulations). In contrast, other firms may choose to maintain distinction between their trading and/or research platforms for different legal entities.

Significant reforms to the FCA’s dealing commission regime would make it difficult for investment management firms to maintain integrated research and trading operations. First, the existing regulatory regimes in other jurisdictions may make it challenging or not feasible to implement the UK changes in that jurisdiction. Second, market participants in non-UK jurisdictions may be reluctant or unwilling to operate under the UK’s provisions with respect to only certain transactions, whether due to operational complexity, financial impact, or other reasons. Third, the operational complexity and the compliance burden may be too great to justify the benefits.

IV. Concerns Regarding Proposed Changes and Potential Consequences

We recognize that, even considering how dealing commission is regulated in other jurisdictions and the impact of changes by the FCA on global investment managers, the FCA may nevertheless determine to proceed with the reforms it proposes in the Consultation, and subsequently with wider
reforms to its dealing commission rules. We raise, for the FCA’s consideration, our questions and concerns regarding the changes proposed in the Consultation.

**Impact on Small and Medium-Sized Investment Managers**

The Consultation states that the proposed change to corporate access should enable investment managers that have lower turnover to more readily gain access to issuers and level the playing field for investment managers who arrange their own access directly with an issuer or use independent third parties. We are concerned, however, that the proposed change may not achieve these goals and instead will reduce access to issuers, particularly for small and medium-sized investment managers who have previously been afforded access through the use of dealing commission.

Small and medium-sized investment managers, due to their size and stature, may be less able to independently arrange meetings with issuers without an intermediary. Unlike large investment managers, they will therefore need to use the services of a broker and be required to pay for such meetings out of their own profits or charge their customers directly, thereby being placed at a competitive disadvantage to larger investment managers.

If wider reforms were adopted – such as prohibiting the use of dealing commission to pay for research – we believe that the impact on small and medium-sized managers would be amplified. Specifically, small and medium-sized investment managers with more limited financial resources could ultimately have reduced access to research. Because of the uncertainty of the impact of the proposed changes, we urge the FCA to gather data and undertake further analysis of this issue to ensure that any changes do not inadvertently disadvantage a category of investment managers.

**Corporate Access – Incidental Assistance**

We understand that, in certain circumstances, a broker may provide *incidental assistance* in arranging corporate access for an investment manager, even though the investment manager does not pay the broker for corporate access out of brokerage commission and does not use corporate access as criteria in evaluating its brokers’ performance in its broker poll. This will typically occur outside of broker or corporate issuer sponsored deal roadshows (the costs of which would be borne by the broker or corporate) in circumstances where the corporate issuer would meet the investment manager in any case, irrespective of any broker involvement, because of the investment manager’s size and investment approach. Given this, the broker’s role is only incidental in that having both parties as clients, the broker is well placed to provide administrative assistance in arranging a meeting. Any value attached to such service therefore is *de minimis*.

The FCA also should note that pricing is not currently generally available from the sell-side for such incidental arranging services, so ascribing a value (however small) to such services is difficult and
administratively burdensome, particularly without sell-side input. Furthermore, as incidental corporate access is currently an unpriced service, applying the FCA’s mixed usage methodology is not a realistic proposition for investment managers.

If the investment manager does not pass on any charges to its customers for incidental corporate access, we believe that simply receiving this service is not prohibited under the proposed COBS 11.6.3R(1), which only relates to goods and services in relation to which the investment manager passes charges back to its customers. Instead, we consider that it is appropriate that the receipt of incidental corporate access which is neither paid for out of dealing commission by the investment manager nor taken into account in evaluating brokers, ought to be dealt with by way of an appropriate non-monetary benefit inducement disclosure under COBS 2.3.1R(2)(b). Accordingly, we ask the FCA to confirm that it shares this understanding as to how the dealing commission and inducements rules apply to incidental corporate access that is not paid for out of dealing commission and not recharged to clients, and to recognize this in the amendments to the COBS rules. We further request that the FCA detail any specifics regarding the disclosure that must be made or conditions that must be met, if any, in order for an investment manager to take this approach.

Revisions to Definition and Interpretation of Research

While we agree that reasonable limits should be placed on what dealing commission may be used for, we do not see a need for the FCA to more tightly circumscribe how research is defined. Specifically, we believe that the FCA should not proceed with proposed changes to the research exemption (COBS 11.6.3 R(2), 11.6.4E(1) and 5E(1)). This change would eliminate the “reasonable grounds” standard under which investment managers currently operate and replace it with a much stricter objective standard that imposes liability on an investment manager, regardless of a manager’s good faith or the reasonableness of its determination. We believe that imposing a strict liability standard for these transactions is not merited.

To the extent the FCA nevertheless proceeds with the revisions, we have concerns regarding how the proposed revision may be interpreted and implemented. Primary among our members’ concerns is that different investment managers may reach different good faith conclusions regarding whether a particular good or service represents eligible research. In certain instances, this may occur because of differences in investment analysis (for example, a conclusion that is meaningful to a

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8 For example, at a broker-led analyst conference (of a type which would qualify as research eligible to be paid for from dealing commission), investment managers may also have one-on-one sessions with company management. Ascribing a price to each investment manager’s pro-rata share of any costs involved in arranging such meetings would become such a complex accounting exercise that the resources involved in the exercise may well exceed any price ascribed to the broker’s service.

9 For comparison, under U.S. law, Section 28(c) of the Securities Exchange Act of 1934 requires an investment manager to determine in “good faith” that the amount of commission paid is “reasonable in relation to the value of the brokerage and research services provided.”
fundamental investment manager may not be meaningful to a quantitative investment manager). However, different investment managers employing the same investment analysis techniques may also come to different conclusions. We request that the FCA clarify in any final guidance that application of the criteria used to determine what is “substantive research” is subjective and acknowledge that a good or service may constitute “substantive research” to one investment manager even if that good or service would not constitute “substantive research” to another investment manager.

In addition, we are concerned that the proposed revision to COBS 11.6.3R(2) and 11.6.5E(1) may indicate an intent by the FCA to further limit items that have previously reasonably and legitimately been considered exempt research from now being considered substantive research. In this regard, we request that to the extent that the FCA determines that certain items should not be permitted to be treated as exempt research, the FCA explicitly include such items on the list of items that are not exempt, as it has proposed to do with corporate access. We also would urge the FCA to recognize that certain services are permitted to be paid for out of dealing commission in other jurisdictions and seek to align its approach wherever possible (including further consideration of the U.S. approach to permitting corporate access as a “research service”). Clarity regarding the FCA’s expectations regarding exempt and non-exempt items and the meaning of the term “substantive research” will make a significant difference in easing the compliance burden and challenges imposed upon investment managers. It also will help ensure that investment managers comply with the FCA’s rules on a uniform and consistent basis, ultimately meeting the FCA’s objectives.

We are further concerned that requiring research paid for with dealing commission to meet all of the criteria to be considered “substantive research” will create compliance burdens and lead to a less efficient use of an investment manager's resources. For each service received, the responsible personnel at an investment manager will need to devise an appropriate oversight process to evaluate whether that service meets the criteria, which will be labor and time intensive. We recommend that the FCA confirm that this process can be proportionate and may be based on a category/sampling approach; any process based on evaluating each piece of research would simply not be practical in terms of the resources required.

As discussed more fully below, we also stress the importance of requiring the sell-side to clearly identify to investment managers what research does or does not satisfy the criteria to be eligible to be paid for out of dealing commission so an investment manager does not carry the burden of identifying such research by itself.

Necessity of Sell-Side Engagement

The Consultation recognizes that the sell-side is integral in the dealing commission regime and that engagement with the sell-side is key to achieving a response that improves transparency and market integrity in this area. We fully agree with this position.
Financial Conduct Authority
25 February 2014
Page 9 of 11

As the FCA is aware, under the current dealing commission regime, research providers do not ascribe a price to research. The price is commonly negotiated *ex post* and investment managers are not aware of the price paid for such research by other firms. On their own, investment managers do not practically have the ability to change how the dealing commission regime operates. The FCA appears, however, to be placing an obligation solely on investment managers. Investment managers would greatly benefit from greater engagement by the sell-side regarding more consistent categorization or labeling of goods and services in order to remove any ambiguity and assist investment managers in their determination of whether a particular good or service meets the substantive research criteria.

We therefore believe that the FCA should not move forward with its proposals until, and unless, it also requires the sell-side to provide the necessary information to investment managers to facilitate compliance with the changes made by the Consultation. Without obligatory sell-side input, the proposed changes will subject investment managers to additional costs and significant liability risks without generating meaningful information for investors. We offer our assistance to the FCA in determining what investment managers may require to facilitate compliance with any new requirements or positions.

**Clarify Jurisdictional Application**

We urge the FCA to give serious consideration to the jurisdictional application of its new regime, and unless and until there is international regulatory convergence, clarify that any new rules will only apply on a narrow basis so as to minimize any issues that may arise. For example, the FCA could consider explicitly clarifying that the new COBS dealing commission rules only apply where: (i) the discretionary investment management decision is made by a UK manager; and (ii) the subsequent trade is executed by that UK manager. If discretionary investment management or trade execution is performed by an affiliated manager based outside the UK (under a delegation or inter-company arrangements) then COBS dealing commission rules should explicitly not apply.

V. **Considerations with Respect to Wider Reforms to the Dealing Commission Regime**

The Consultation seeks feedback regarding the potential for wider reforms to the dealing commission regime. The impact of any wider reform, of course, depends on the nature of such reforms, which could range from refining the current system to restricting or eliminating the use of dealing commission to purchase research.

**Impact on Small and Niche Issuers**

Wider reform could reduce the availability of high quality research, particularly research relating to smaller issuers or niche markets and issuers (such as emerging and frontier markets) that are not widely followed, a point that was recognized in the 2007 Review.\(^{10}\) Investment managers might be

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\(^{10}\) 2007 Review at 8.
less willing to pay for research in “hard” dollars and the producers of the research might be forced to limit the research coverage provided. In addition, the number of firms that provide research on such issuers may decline due to a reduction in available commission dollars.

**Elimination of Benefits Resulting from Existing Regime**

The current regime for the provision of research on a bundled basis has many benefits; further changes to the dealing commission regime may eliminate some or all of these benefits to the detriment of investment managers and their clients. Among the benefits of the current bundled brokerage regime is broad coverage/availability of research due to economies of scale. In today’s environment, many research providers provide multiple perspectives, which is valuable to investment managers. Further, because the marginal cost of research is relatively low, research also may be provided to a large number of users, allowing both producers and consumers of the research to benefit from economies of scale. This broad coverage benefits both investment managers that rely solely on outside research, as well as managers with substantial in-house research capability, as they provide the benefit of another perspective. In addition, greater coverage of stocks also helps to keep markets well-informed and functioning most efficiently. This ultimately benefits small and medium-sized investment managers that would otherwise not be able to obtain such research.

In addition, the interests of investment managers and clients can be aligned under a bundled dealing commission regime. Investment managers seek to negotiate commission rates that provide clients with best execution and appropriate access to research; they avoid paying unduly high commission rates because the cost of commissions affects the performance of a fund or client portfolio. Similarly, the current regime provides investment managers with a degree of flexibility and discretion regarding the valuation of and payment for research it receives. This flexibility benefits clients by helping to ensure that investment managers do not pay (or overpay) for research that they do not value.

Further, the current global regulatory environment for dealing commission - in which bundled brokerage is permitted - allows investment managers to establish and benefit from a number of global relationships. As described above, significant divergence in regulatory approaches creates challenges for operating global platforms and can increase costs, to the detriment of clients.

The bundled brokerage model can continue to provide an effective and efficient way of providing access to execution and research services at a competitive rate if it is combined with appropriate oversight and controls. Appropriate oversight and controls may include consideration of the type and value of research paid for with dealing commission and the adoption of research budget mechanisms to monitor the amount of dealing commission spent on research. We therefore urge the FCA to consider further refinements to the current system rather than adopting a more radical approach that further restricts or eliminates the use of dealing commission to purchase research.

Given the potential consequences of wider reform to the global dealing commission regime, we recommend that the FCA issue a consultation requesting comment on any changes prior to taking
further action in this area. In this manner, the FCA can carefully consider the impact of further reforms on investment managers.

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We offer our assistance as the issues under the Consultation continue to be examined. If you have any questions on our comments, please feel free to contact the undersigned, Ari Burstein at 1-202-371-5408 or aburstein@ici.org, or Eva Mykolenko at 1-202-326-5837 or emykolenko@ici.org.

Sincerely,

/s/ Dan Waters

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cc: David Wright
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