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Submitted via email to dp14-03@fca.org.uk

Wholesale Conduct Policy Team
Markets Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Re: Discussion on the Use of Dealing Commission Regime (DP14/3)

Dear Sir or Madam:

ICI Global¹ is writing to respond to the Financial Conduct Authority's (FCA) discussion paper on the use of dealing commission regime (Discussion Paper).² As we expressed in our response to the FCA's consultation earlier this year on the use of dealing commission rules,³ 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. Based upon a thematic supervisory review and a high level cost benefit and competition analysis, the FCA concludes in the Discussion Paper that unbundling research from dealing commissions is the most effective option to address the conflicts of interest created by the use of transaction costs to fund external research. The FCA also hopes this approach is adopted on an EU-wide basis through the revised Markets in Financial Instruments Directive (MiFID II).

¹ The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US\$18.8 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

² See DP 14/3 Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research (July 2014), available at <http://www.fca.org.uk/news/dp14-03-the-use-of-dealing-commission-regime>.

³ See Letter from Dan Waters, ICI Global, to Adam Wreglesworth, Financial Conduct Authority (25 February, 2014), available at <http://www.iciglobal.org/pdf/27918.pdf>.

We are pleased that, prior to taking further action, the FCA is seeking input on its analysis in the Discussion Paper and maintaining an open dialogue on the use of dealing commission and the market for research. As many ICI Global members operate global businesses with asset management operations in the United Kingdom (UK) among other jurisdictions, the issues raised in the Discussion Paper are of significant interest for our members. Many of the points that we raise in this letter are substantially the same as those raised in our response to Question 79 of the European Securities and Markets Authority (ESMA) MiFID Consultation.⁴

I. Thorough Cost Benefit and Impact Analysis is Needed Prior to Fundamental Change to the Existing Research Regime

As we stated in our response to the ESMA consultation, change to the research and dealing commission regime of the magnitude contemplated by ESMA, and supported by the FCA, should be undertaken only after a proper impact analysis that thoroughly considers the benefits and consequences of the changes under consideration. ESMA is preparing an impact assessment for the technical standards and gathering data to support its technical advice. We believe that this assessment must include a fulsome consideration and analysis of the impact, including any benefits, of any proposed changes to the interpretation of research and the use of dealing commission.

In section 5 of the Discussion Paper, the FCA outlines the wider outcomes and impact of research unbundling that it anticipates occurring, based on earlier work of the FCA's predecessor in developing the current regime and recent research by external parties. We note with concern, however, that the FCA has supported dealing commission reforms on the basis of only a "*high level cost benefit and competition analysis*." The FCA's analysis in the Discussion Paper is, in our view, rather cursory and conclusory, and is not substantiated by evidence. In contrast, the Financial Services Authority in 2003 commissioned OXERA to undertake a thorough and substantial cost-benefit analysis of its policy propositions concerning dealing commission and bundled brokerage services.⁵ As described in the next section, we anticipate markedly different outcomes than the FCA, should the UK and/or EU proceed with unbundling execution from research.

Considering the potentially significant impacts of unbundling research from dealing commission, and widely differing views on anticipated outcomes, we urge the FCA to undertake or commission a thorough analysis of the market impact of unbundling, with public input, to fully understand the effect on investment firms and their clients, as well as on the market and firms providing research. We believe that an assessment and analysis, similar in depth and scope to that

⁴ The ICI Global response to the European Securities and Markets Authority (ESMA) on its consultation for the implementation of the revised Markets in Financial Instruments Directive (MiFID II) and Regulation (MiFIR) is available at <http://www.iciglobal.org/pdf/28294.pdf>.

⁵ OXERA reports, *An Assessment of Soft Commission Arrangements and Bundled Brokerage Services in the UK and Cost-Benefit Analysis of the FSA's Policy Propositions of Soft Commissions and Bundling* (April 2003). These papers are available at <http://www.oxera.com/Oxera/media/Oxera/downloads/reports/Assessment-of-Soft-Commissions-and-Bundling-report.pdf?ext=.pdf> and <http://www.oxera.com/Oxera/media/Oxera/downloads/reports/FSA-regulation-of-soft-commissions-and-bundled-brokerage.pdf?ext=.pdf>.

undertaken over ten years ago by OXERA, is necessary to allow for an informed dialogue and decision on the best way to serve investors while considering the impacts. We encourage the FCA to liaise with ESMA to engage in such analysis on a broader level. We also note that IOSCO is taking up further work in this area and it would be important for the FCA to take account of that global perspective in coming to a view.

Such an analysis also should take account of relevant conflicts of interest requirements and how such requirements could affect research and dealing commission arrangements.

II. Significant Negative Consequences Would Result from Unbundling

The FCA asks two questions in the Discussion Paper: (1) do you have any comments on our analysis on the potential impact of unbundling payments for research from execution arrangements based on MiFID II proposals (Option 1, implemented across the EEA), and (2) do you have any analysis that would help inform our view of possible benefits or costs of extending requirements in MiFID II to cover all research goods and services (Option 2, implemented only in the UK and assuming ESMA proposal is adopted for the EEA).

In our view, the implementation of either Option 1 or Option 2 would have significant negative consequences that would disproportionately harm the provision of research, small and medium-sized issuers, small or niche research providers, and certain investment firms. Our concerns are described in detail below.

1. Challenges for Global Investment Firms

Many global investment firms currently operate trading and research platforms that are fully integrated in order to take advantage of economies of scale, for personnel reasons, and/or for operational alignment. These firms have incurred substantial costs to establish operations in the UK or elsewhere in the EU, anticipating that the global practice of using commissions to pay for research would remain consistent cross border. These firms may apply the same requirements to all their trading and research operations for purposes of global consistency. This is currently possible because existing regulatory regimes on the acquisition of research through dealing commission in the U.S., Europe and the rest of the world are sufficiently similar to permit this approach. In our opinion, this is for good reason, with the benefits of acquiring research from dealing commission having been generally acknowledged.

In an increasingly connected, cross-border financial world, it becomes extremely difficult to accommodate European rules on dealing commission that differ markedly from those adopted elsewhere. Given the global nature of much of investment management, there are many different combinations of circumstances – the clients' jurisdictions, the investment firm's and their affiliates' jurisdictions, and the trading jurisdiction. The adoption of very different European rules, as considered in Option 1, would cause significant operational complexity, increased compliance burdens and costs, with significant disruption to the efficient and effective provision of research across funds and clients at a global level. It also would increase the cost of operating EU subsidiaries

and servicing EU clients. Global investment firms would have to decide whether it is possible to maintain some type of integrated research and trading platform which accommodates the proposed European approach, or whether to bifurcate their approach to deal with different regulatory regimes.

In reality, it would be very challenging for investment firms to maintain integrated research and trading platforms. First, the existing regulatory regimes in other jurisdictions may make it difficult or expensive to accommodate the EU changes. Second, market participants in non-EU jurisdictions may be reluctant to operate under the EU's provisions with respect to only certain transactions (*i.e.*, transactions for that firm), whether due to operational complexity, financial impact, or other reasons. Third, the operational complexity and the compliance burden may be too great to justify.

Conversely, it may be equally challenging for different parts of a global investment firm to comply with regulatory regimes for research and the use of dealing commission that vary greatly. Such an approach would be operationally challenging with significant compliance burdens and costs. We also believe the end result would be increased fragmentation of service provision with the likely impact being increased costs and reduced research for European clients. For large international firms, the inability to continue to use dealing commission to acquire research could be a significant disincentive to doing business in Europe.

Should the FCA determine to proceed with Option 2, with the other EEA member states implementing Option 1, the global firm challenges described above would be magnified because firms would be subject to not only a changed EEA regulatory regime (assuming ESMA's proposal is adopted), but also a changed and more stringent UK regime. Determining which regulatory regime applies to which transactions and clients, and determining how best to structure trading and research operations and regulatory compliance, would be extremely challenging and costly.

2. Impact on Small and Medium-Sized Enterprises

We are also concerned that both Option 1 and Option 2 would harm small and medium-sized enterprises themselves. If investment firms are precluded from using dealing commission to obtain research of any real value (or any research at all), the availability of high quality research, particularly research relating to smaller and medium-sized enterprises that are not widely followed, may be drastically reduced. This concern was recognized in the IOSCO 2007 Final Report on Soft Commission Arrangements.⁶ To the extent there is a contraction of the research provided on such an issuer, this may lead to lower liquidity in the shares of such issuer and wider spreads in the issuer's shares. An increase in the bid/offer spreads would increase the trading/investment cost for investors, thereby making investment in such issuers less desirable. Such a result would be contrary to the EU's recent efforts to promote investment in small and medium-sized enterprises.

⁶ See Soft Commission Arrangements for Collective Investment Schemes, Final Report, Report of the Technical Committee of IOSCO, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf>, at 8.

3. Competitive Disadvantage for EU Firms and Their Clients

In our view, Option 1 and Option 2 would impact the international competitiveness of EU firms, and potentially harm their clients, including regulated funds and their investors. If these changes are made at only an EU level, EU firms would be at a disadvantage compared to U.S., Asian, and other investment firms that are not subject to these requirements and may continue to use dealing commission for permissible research. EU firms would need to pay for such research themselves, charge clients explicitly for research, or create research in-house.

It is incorrect to assume that banning bundled commission payments in Europe would lead to the end of dealing commission arrangements elsewhere. In Hong Kong, dealing commissions are permissible so long as there is a demonstrable benefit to the client. In the U.S., investment managers are permitted to use dealing commissions for research services provided the elements of Section 28(e) of the Securities and Exchange Act of 1934 are met. Specifically, an investment firm is permitted to cause an account to pay more than the lowest available commission if the firm makes a good faith determination that the amount of commission is reasonable in relation to the value of brokerage and research services provided by the broker and so long as the research services assist the investment firm in the investment decision-making process.

Further, EU investment firms and their clients may also be disadvantaged with respect to the receipt of brokerage services from brokers located outside the EU. Because the EU would severely restrict the use of dealing commission for research (essentially requiring unbundling), EU firms may find it challenging, or not possible, to separate the execution and research services provided by brokers that are not required to unbundle and do not typically do so. In certain jurisdictions, the brokerage industry may be unfamiliar with unbundling or simply be unwilling to unbundle. In such cases, the commission rate may not be reduced if the EU investment firm, complying with its legal requirements, declines research or other services typically provided by the broker as part of its bundled offering. Although the EU firm could arguably seek to transact with a broker that can accommodate its situation, this may not be possible where brokerage options are limited (and where the potential research that could be provided would, in reality, unlikely impact the investment firm's choice of execution venue).

In addition, global investment firms may currently aggregate trades for clients in multiple jurisdictions in order to take advantage of economies of scale and treat client orders equitably. To the extent that a global firm no longer aggregates trades for EU clients and trades them on an execution only basis, these clients may be disadvantaged. The impact of how transactions for clients of EU firms are traded could reduce the attractiveness of the EU as a location for investment firm operations.

4. Detrimental Impact on Small and Medium-Sized Investment Firms

If either Option 1 or Option 2 are adopted, we expect that small and medium-sized managers would be disproportionately and adversely impacted. Specifically, small and medium-sized investment managers with more limited financial resources may be unable to absorb the costs

of buying research or producing it in house. Due to their size and stature, these firms may also be unable to negotiate terms to pay for research with hard dollars that are equal to those of large firms. Consequently, small and medium-sized firms may ultimately have reduced access to research, whether it is bespoke written reports, meetings with research analysts, or other currently permitted services. This more limited access would consequently damage their business and potentially hurt their clients. A decrease in small and medium-sized firms could ultimately be harmful to consumers as it would reduce industry competitiveness and choice for investors.

5. Impact on Small and Niche Research Providers

Specialist and independent research houses that provide valuable (but relatively expensive) research into emerging market companies, small and medium-sized enterprises, or otherwise expensive-to-research issuers could also be detrimentally impacted if the existing arrangements are disturbed through either the adoption of Option 1 or Option 2. The number of firms that provide research on such issuers may therefore decline. This will ultimately impact asset managers, too, as they will have more difficulty obtaining high quality research on these securities.

A narrower range of views about stocks from a reduced number of research providers could lead to a reduction in liquidity, and significantly limit information in the marketplace. Investors are better served when more rather than less information and opinions are available in the marketplace because broadly available higher quality information results in more efficient markets and better price discovery.

6. Elimination of Benefits Resulting from Existing Regime

The current regime for the provision of research on a bundled basis has many benefits; adoption of either Option 1 or 2 may eliminate some or all of these benefits to the detriment of investment firms and their clients. Among the benefits of the current bundled brokerage regime is broad coverage and availability of research due to economies of scale. In today's environment, having many research providers promotes the availability of multiple perspectives. 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 firms that rely solely on outside research, as well as firms 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 also benefits small and medium-sized investment firms that would otherwise not be able to obtain such research.

We continue to believe the interests of investment firms and clients can be aligned under a bundled dealing commission regime. Investment firms seek to negotiate commission rates that provide clients with best execution and appropriate access to research; they have incentives to 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 firms with a degree of flexibility and discretion regarding the valuation of and payment for research. This flexibility

benefits clients by helping to ensure that investment firms do not pay (or overpay) for research that they do not value. In addition, under the current model, research providers bear the fixed expenses related to research, and investment firms are able to switch research providers without downside financial risk. This model benefits investment firms as well as investors because investment firms are able to utilize a large quantity of research for the benefit of investors, and only pay for the research they find useful.

We believe a fixed price model may have the effect of reducing research available to managers, and thus providing less information for the investment decision-making process. This would not be in the best interest of investors. Although research is currently paid for out of commissions, managers are disincentivised from overpaying brokers because this would impact the manager's performance figures (which are very significant to investors).

Further, the current global regulatory environment for dealing commission - in which bundled brokerage is permitted - allows investment firms to establish and thereby provide clients with benefits from its global relationships. As described above, however, a significant divergence in regulatory approaches will create challenges and burdens for global platforms, to the detriment of clients.

In our view, 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, which may include:

- a) Regular review of the type and value of research paid for with dealing commission.
- b) Adoption of research budgets or other mechanisms to monitor the amount of dealing commission spent on research. These should be set at suitable frequency, typically not less than once a year. Clear controls should be in place to determine how and when any such research budgets or other mechanisms are altered.
- c) Separation of trading and investment functions *i.e.*, the trading desk should focus on seeking best execution when dealing with brokers, and the research portion of the commissions should be guided by the investment staff utilizing the research.
- d) Commission sharing agreements (CSAs), which eliminate the need to direct trades to a particular broker in order to pay for research from that broker. CSAs allow the buy-side to recognize brokers who produce good research, without being under any obligation to recognize them by directing trades to them.
- e) Commission recapture arrangements to claw back commissions once budgets are reached.
- f) Creation of a committee that sets broad policy direction, and reviews decisions of working groups.
- g) Reports to clients on the use of commissions to assist clients in understanding client commission practices.

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

Sincerely,

/s/ Dan Waters

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