CAPIS Connect

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FCA Rule Changes – Research Commissions

In May 2014, Policy Statement (PS) 14/17 was published by the UK's regulatory body, the Financial Conduct Authority (FCA), formerly known as the FSA, implementing new guidance for the use of dealing commissions (client commissions) to obtain goods and services (research).

The new rules, which were implemented on June 2, 2014, were designed to provide guidance and clarity on existing rules. Additional clarifications and rule implementations could come later this year as the FCA continues to perform a broader scope of their work with regard to the use of client commissions to pay for research.

Background

At the FCA's Asset Management Conference in October 2013, the FCA set out to review the use of commissions by investment managers. They wanted to "ensure investment managers seek to control costs passed onto their customers with as much rigour as they pursue investment returns."

The FCA felt the majority of investment managers had inadequate controls and oversight when using client commissions to purchase goods and services.

Summary of New Rules

- **"Reasonable Grounds"**

  There are three provisions that must be met for research to be obtained through client commissions - (1) the good or service reasonably assists the investment manager in the provision of its services to its clients, (2) the receipt of the good or service must not impair an investment manger's duty to act in their client's best interests ***and*** (3) the good or service they are receiving is directly related to execution services on behalf of its customers or provides substantive research.

  Previously, investment managers could use a "reasonable grounds" determination on all three provisions when assessing if client commissions could be used to pay for a good or service. The new guidance states that the reasonable grounds determination now only applies to the first requirement while the second and third requirement now need an absolute yes or no assessment.

  This new rule change provides tighter controls on meeting the three provisions.

- **"Substantive Research and Meaningful Conclusions"**

  Research that is provided through client commissions must be "substantive" and provide "meaningful conclusions".

  For research to be substantive, it must:
  - Be capable of adding new insights that assist in the investments manager's decisions
  - Represent original and intellectual thought

- Provide the asset manager with meaningful conclusions based on analysis or manipulation of data rather than simply providing information from which an investment manager can draw its own conclusions

Research that provides meaningful conclusions is a key feature that distinguishes general information services from substantive research. General information services, such as market data, are not allowed to be paid with client commissions whereas substantive research is allowed.
Any research that is received but does not "reasonably assist" the investment manager is not eligible to be paid with client commissions.

- **Corporate Access**
  Investment managers are now prohibited from using client commissions to pay for corporate access.

  Corporate access is viewed by the FCA as an "arranging or bringing about contact between an investment manager and an issuer or potential issuer" and thereby does not meet the definition of substantive research.

  Where corporate access is offered as a bundled service, the investment manager must make a reasonable assessment as to the value of the corporate access service and separate that amount from the eligible research amount.

- **Mixed-use Assessment**
  In PS 14/17, the FCA provides additional guidance on mixed-use goods and services. Where a good or service is deemed mixed-use, the FCA suggests using a "fact-based analysis" to determine the eligible and ineligible portions of a good or service. Such fact-based analysis could include:
    - Determining the price of similar goods or services in the marketplace
    - Estimating what a manager's cost would be if they provide a similar good or service internally
    - Determining the amount the manager would pay for the ineligible amount of the good or service to ensure they are not overcharging the client through commissions

  In order for managers to properly assess mixed-use goods and services, cooperation and information sharing from sell-side brokers and other third-party sources is essential.

Conclusion
The revised rules were implemented to ensure that client commissions are only used to acquire eligible goods and services and that costs are subject to increased controls. Only goods and services that are directly related to the execution of trades or the provision of eligible research are permitted to be paid with client commissions.

Investment managers should have a clear and rational process for determining if a good or service can be paid with client commissions, with proper documentation to reflect this process. Additionally, managers should ensure disclosure to clients is sufficient with regard to their practice of using client commissions to obtain goods and services.

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