CAPITAL INSTITUTIONAL SERVICES, INC.

March 2015

FCA's Response to ESMA's Final Proposal Regarding Dealing Commissions

Last month, we wrote about the European Securities and Markets Authority's (ESMA's) final technical advice regarding the implementation of Markets in Financial Instruments Directive (MiFID II). In response to ESMA's final proposal, the Financial Conduct Authority (FCA) has issued a Feedback Statement to Discussion Paper 14/3 - Discussion on the Use of Dealing Commission Regime. The FSA waited to release their guidelines until ESMA released their final proposed guidance for MiFID II implementation.

The FCA's Response

The FCA strongly supports ESMA's final advice and believes the proposal achieves the main objective of separating payments for research from execution. They both agree that:

- Research from commissions is an inducement and therefore a conflict of interest
- The need to separate research costs from execution costs in order to better align a portfolio manager's incentive to control costs and receive research is in the best interest of their clients
- There should be more transparency and disclosure on placing a monetary value on research

While the FCA generally agrees with ESMA on their final proposal, there is one key point that they do not agree with; the ability to use commission sharing arrangements (CSAs) to pay for research.

ESMA's final advice outlines what they believe to be a positive model for how research can still be paid for with client commissions so that it doesn't constitute an inducement. Under ESMA's approach, CSAs would facilitate the unbundling of research from execution costs with specific rules that would govern how they operate. Dedicated "research payment accounts" would be set up, funded by a specific charge to the client based on a budget agreed to in advance. The research amount allocated would be based on the investment manager's external research needs and not tied to trading volume or values. Research budgets could only be increased with the written consent of the clients.

On the other hand, the FCA disagrees on the use of CSAs to facilitate the unbundling of research from execution costs as they believe CSAs are "incompatible with the intention of ESMA's proposals" which state that payments for research cannot be linked to the volume of transactions. In the FCA's opinion, using CSAs still ties research payments to the volume of executions done on a client's behalf.

The FCA interprets ESMA's final advice as a way to create a "hard dollar" research market with research being paid for by the investment manager or through a research payment account. The FCA believes that separate research accounts should be set up and funded in advance with an amount agreed to between the investment manager and client. The key difference here is that while both regimes agree that a budget needs to be set up in advance and agreed to by all parties, ESMA believes the budgeted research can be paid for using CSAs and the FCA believes the client should pay up front as a separate charge. Essentially, under the FCA model, using commissions to pay for research would be banned.

Concerns

Not everyone agrees with the FCA's stance and many are concerned of the ramifications if CSAs are not allowed to be used in the MiFID II implementation.

French regulator, the Autorité des Marchés Financiers (AMF), believes the FCA is being too stringent and feels that CSAs could work if proper guidelines are put in place. The AMF's General Secretary, Benoît de Juvigny, believes that the ESMAs proposal doesn't fully ban the use of CSAs and doing so "could increase the difficulty to finance research, particularly for smaller companies, where it is already difficult to find research." Numerous market participants agree that the FCA approach is too onerous in implementation and could disadvantage the competitiveness of European firms relative to other regions.

The FCA believes these new proposals will foster increased competition in the research space, increase the number of research providers, and drive more innovation and specialized research products.

What's Next?

The European Union (EU) must perform a full impact study of the proposals. Final legislation will be drafted by the EU through Designated Acts and is expected to be published in mid-2015. The EU will take into account the ESMA's final advice as well as the views of the European Parliament and the European Council when drafting the final rules. The final Delegated Acts are expected to be adopted no later than January 2016. Member states must then adopt and publish measures in domestic law and regulations by July 3, 2016. Implementation of MiFID II will become effective January 3, 2017.

Glossary of Terms

European Securities and Markets Authority (ESMA) – is an independent European Union (EU) Authority that contributes to safeguarding the stability of the EU's financial system by ensuring the integrity, transparency, efficiency, and orderly functioning of securities markets, as well as enhancing investor protection.

Financial Conduct Authority (FCA) – The Financial Conduct Authority is a financial regulatory body in the United Kingdom. The FCA regulates financial firms that provide services to consumers and maintains the integrity of the UK's financial markets. They focus on the regulation of conduct by both retail and wholesale financial services firms.

European Union (EU) – The European Union is a political and economic partnership between 28 European countries. The EU operates through a system of supranational institutions and intergovernmental negotiated decisions by the member states.

Autorité des Marchés Financiers (AMF) – regulates participants and products in France's financial markets. It regulates, authorizes, monitors, and where necessary conducts investigations and issues sanctions. In addition, it ensures that investors receive material information, and provides mediation service to assist them in disputes.

European Council (EC) – The members of the European Council are the heads of state or government of the 28 EU member states, the European Council President, and the President of the European Commission. The EC defines the EU's overall political direction and priorities. It does not negotiate or adopt EU laws but sets the EU's policy agenda, traditionally by adopting "conclusions" during European Council meetings which identify issues of concern and actions to take.