10 October 2014

FCA DISCUSSION PAPER

(ref: DP14/3)

Discussion on the use of dealing commission regime

Sell side and Buy side position (AFG & AMAFI)

Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. 600 management companies are based in France. AFG members manage 3,000 billion euros, making the Paris fund industry a leader in Europe for the financial management of collective investments (with 1,500 billion euros managed from France, i.e. 19% of all EU assets managed in the form of investment funds). In the field of collective investment, our industry includes –beside UCITS – the whole range of AIFs, such as: employee savings schemes, regulated hedge funds/funds of hedge funds, private equity funds, real estate funds and socially responsible investment funds. AFG is an active member of the European Fund and Asset Management Association (EFAMA) and of PensionsEurope. AFG is also an active member of the International Investment Funds Association (IIFA).

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI has more than 120 members operating for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives. Nearly one-third of its members are subsidiaries or branches of non-French institutions.

The two associations above, representing the **buy-side and sell-side in French markets**, welcome the opportunity to comment on the FCA discussion paper (DP) on the use of dealing commission regime. AFG and AMAFI decided to answer this consultation, primarily intended for the British market, owing to the following reasons:

- Many clients of the French brokers are UK based asset managers, hence being directly affected by any change in the regulatory framework of their clients.
- French asset managers have subsidiaries in London which would be directly impacted by the UK regime of dealing commissions.
- In its DP, the FCA establishes a clear connection[1] between its leaning for an overhaul of the dealing commission regime and the current reform being discussed on the same matter at the European level, within the framework of MiFID II implementing measures concerning inducements.

[1] "*This DP serves to further the evidence base and analysis on this topic during ESMA's consultation.*" (*FCA DP 1.14*).

On this later point, AFG and AMAFI underscore that the only question raised by the FCA in the DP concerns a possible extension of the unbundling to all research products and not only to non-minor monetary benefits as proposed in ESMA's paper. This question appears to be minor compared to what is at stake with this reform for the business model of financial intermediaries, which would be greatly impacted even if the reform is only pursued according to today's ESMA proposal.

At this stage, the FCA is not considering the establishment of a specific UK regime in case a final European rule would be less stringent than expected today. Since the British regulator plainly develops its reasoning in the wake of ESMA's considerations on the qualification of research as an inducement, the Associations want to start answering by recalling why this approach is wrong-headed.

AFG and AMAFI responded to the ESMA's consultation paper. As the great majority of the comments received on that point during the consultation and as ESMA's own Securities and Markets Stakeholder Group, we have a very strong negative opinion on the proposals drafted by ESMA. For the main reasons developed in Appendix 1 of this document, we consider that such an evolution would have required to be discussed at level 1 by the European Council and Parliament, which was not the case. If the FCA is free to set up for fund managers who are under its jurisdiction, a stricter regime than the one provided in Europe, it cannot hinder the principles of the European passport.

That being stated, the following comments must be read while bearing in mind that the recent French regime on dealing commissions is similar to the UK one. Indeed, in 2007, the *Autorité des marchés financiers* (AMF) adopted a set of rules which:

- define what could be compensated through dealing commissions: order reception and transmission services, order execution services on behalf of third parties and [investment decision aid services and order execution services (Investment Advisory Services, IAS)]. The list of eligible IAS was also précised through an AMF "instruction";
- impose a transparency regime for asset management companies which are obliged to disclose the breakdown between intermediation fees and IASs' fees;
- define a Commission Sharing arrangement mechanism.

Those rules are listed in *Appendix 2* of this document.

In the meantime, AMAFI (named AFEI at that time) and AFG were deeply engaged in the discussions surrounding the setting up of the new regime and issued a common "Charter of Good Practice" which constitutes a framework for broker compensation by investment managers. In particular the Charter proposes a mechanism of a "broker review" by which investment manager and brokers determine the value of execution and IASs services. The Charter is available at the following link: http://www.amafi.fr/images/charte%20afei-afg%20-%2017-07-2006%20-%20en.pdf.

Moreover, AMAFI and AFG worked on the clarification of the legal, accountancy and tax components of the regime of both asset management companies and brokers. The Associations issued a series of documents enabling the operational functioning of the CSA whatever the nationality and the fiscal regime of both asset management companies and brokers. (http://www.amafi.fr/images/stories/pdf/docs/fiscal/08-42EN.pdf).

In this context, AFG and AMAFI read with much attention the findings of the FCA surveys which tend to show that the functioning of the current British model for the payment of investment research could be improved, notwithstanding the several reforms introduced in the last decade to limit the conflicts of interest and certain questionable practices.

Providing the best service to clients is crucial for the industry (buy side as well sell side), and that is why rules limiting conflicts of interest and increasing transparency are supported by our members.

However, AFG and AMAFI **do not support the main conclusion of the FCA**, which claims that a complete overhaul of the current regime should be envisaged since this would be the only way to solve the problems underlined, following the apparent insufficiency of the results brought by the last reforms in the eyes of the regulator. Moreover, nothing in the finding or in the discussion paper shows that the possibilities offered by the existing regime do not enable the identified flaws to be redressed.

The series of arguments advanced by the FCA to radically reshape the remuneration of investment research can be questioned. In any case, they do not automatically entail an abandonment of the current regime.

In particular, we strongly disagree with the alleged difficulty to limit, under the current regime, the use of dealing commissions to pay other services (i) and the assumption that research payment is bound to be linked to the trading volume (ii), what the facts contradict. The Associations consider that there are solutions so as to reinforce the control on budgets under the current regime (iii). And above all, AFG and AMAFI consider being inappropriate for the FCA to interfere in the pricing model of research, given that it is not a conflict of interest issue (iv). Finally, the Associations regret that the FCA has neglected, in its analysis, the potential effects of its proposal on issuers (v).

(i) Ensuring a proper use of dealing commissions is key and manageable under the current framework

AFG and AMAFI consider that it is of prime importance that the dealing commissions are directed to remunerate only the services listed by the competent authorities. The regime currently in place in the UK, rather similar to the one existing in France, was elaborated so as to restrict the use of dealing commissions to research (which was a real progress comparing to the former “soft commission” regime), and thus provide safeguards with a determination of what can be paid by dealing commissions. We recognise that improvements can still be added because there are probably “grey areas” where the delineation between authorised and forbidden services is not obvious. This may be the case, for instance, for services provided by market data vendors. On this matter, further guidelines could be usefully provided by the regulators.

Nonetheless, AFG and AMAFI do not think that the exceptional cases of breaches mentioned in the FCA DP, can be sufficient, by their very existence, to justify a complete change of regime. The FCA does not provide any evidence that these breaches are not already punishable under the existing framework, and that a strict enforcement is sufficient to handle this problem.

(ii) The link between research payment and trading volumes can be managed within the current regime

AFG and AMAFI are rather surprised by the repeated reproach on the supposed inherent link between the amount paid to research providers and the volume of trading. This key element of the FCA stance is exaggerated. Indeed, it is quite easy for an asset manager operating through CSAs to pilot the amount of research compensated to IAS providers: since execution and research rates are explicitly differentiated, asset managers can easily lower (or increase) the research rate when, for a given period, the amount provisioned for IAS exceed (or fall behind) the forecast amount / budget. This behaviour is an illustration of the flexibility which prevails in the existing system.

We do not contest the fact that, in some instances, this good practice is not applied, which impairs a fair remuneration of research. A move towards the generalisation of this practice should then be supported.

Besides that, the current overrepresentation of the allocation to the brokers carrying out the execution in CSAs, that the FCA seems to consider as a flaw of these schemes when pointing out that “The largest brokers still attract a significant share of research commission payments”, can be easily explained. For many years, and before the implementation of the CSA’s framework, global brokers have been making huge investments in both execution services and research in order to fulfil their client’s needs. It is therefore not surprising that they still receive a significant share of research payments, given the quality of services they provide.

(iii) Budget controls can improve research procurement and should be encouraged

AFG and AMAFI do not deny that budgetary planning and control may be insufficient for some asset managers in relation to research payment. This can be explained to some extent by the difficulty to anticipate the pricing of research in the current model (*see next point infra*).

However, good practices, such as the generalisation and improvement of the “broker review” should be strongly encouraged, since good budgeting and payment controls can limit the drawbacks identified in the precedent points. In particular, a split between the execution vote and the research vote (i.e. imposing two specifics “broker reviews”) constitutes a key element, which is already applied by the main asset managers. Moreover, the budgeting (in money value) by asset management companies of the external IAS flows should be encouraged. We are of the view that the issue of guidelines by the regulator, resting on identified best practices, is appropriate to fit the needs of regulatory concerns.

(iv) The question of research pricing is out of the scope of market regulators’ power

AFG and AMAFI are also rather surprised that the FCA tends to consider that the pricing model of research constitutes a regulatory concern. Indeed, the pricing model is not able to raise any particular conflict of interest issue. Would a problem be identified in this field, it should be tackled by Competition Authorities.

The pricing model falls within the scope of natural commercial relationship between clients and suppliers of research services.

More specifically, the FCA’s suggested model, based on ex ante pricing model may in certain conditions fit the needs of a part of the business. But, in many instances, indeed, the value of research does not depend upon its costs, but mainly on the relevance and the quality of the advice provided to the asset manager in relation with its decision to buy or sell a given stock or invest in a particular sector of activities or a geographic zone, which will give value first to the portfolio, and, at the end of the day to the final clients. In many instance, research brings additional value to the work done by the fund manager, and as such, as to be priced in consideration.

(v) No proper assessment of the consequences induced by the envisaged change on issuers in their ability to raise funds.

The FCA’s analysis is mainly focused on the potential drawbacks of the current situation for investors. It does not take into account the potential outcomes of the proposed reform for issuers. Indeed, the FCA almost only mentions issuers in relation to conflicts of interest, never contemplating how these changes can affect them, which we consider cannot be ignored by a market regulator: the market is functioning for the benefit of investors **and** issuers.

In particular, AFG and AMAFI do not share FCA's position stating that the research coverage would stay at the same level would the reform be put in place. This is, in fact, contradictory with FCA's policy goal to drastically diminish the cost of research for investors. We really believe that it would result in an attrition of the research production and of research coverage (*see Appendix 1*). It must be added that firms providing research services are already operating with very low margins. Any decrease in their incomes would necessary lead them to reduce their research coverage.

We cannot forget the existing link between analyst coverage and the cost of capital. Recent academic studies[2] have indeed demonstrated that capital costs increase when analyst coverage ceases and that a decrease in analyst coverage causes a decrease in investment and financing. The less there is of analysts following an issuer, the more there is of asymmetries of information at the expense of investors.

It is why, even if the FCA continues along this path, AMAFI and AFG cannot accept to extend this analysis at European level. What is at stake is not only the business model of sell side and by side industry: at least a deep impact study of all kind of effects attached to such a reform is essential.

As a conclusion, AFG and AMAFI are of the view that the path envisaged by the FCA to reform the compensation of investment research is highly inappropriate. We disagree with the conclusions of the analysis provided by the regulator (which is partial in our opinion) and with parts of its content. In any case, no decisive element has been provided that should justify a complete change of regime. Then, rather than putting at risk a regime that has been improved little by little and that market participants largely support, other ways should be explored, notably with a renewed enhancement of the current model. We reaffirm our support to an effective regime which would be designed so as to bring value to the final client: in this context, we think some sharp improvements to the existing regime can provide more satisfactory results than a total overhaul of the research remuneration.

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[2] See for instance: "The Real Effects of Financial Shocks: Evidence from Exogenous Changes in Analyst Coverage", Derrien F., Kecskés A. *Journal of Finance* 68, 4 (2013).

Appendix 1

Summary of AFG and AMAFI's responses to Q79 of ESMA's Consultation Paper on MIF 2

ESMA's current attempt to reform this regime is not acceptable: such a change would need further evidence and discussions

➢ *The approach is not acceptable and not workable*

AFG and AMAFI were very surprised by ESMA's proposed policy, which comes without prior discussion nor impact assessment. Whilst the bulk of research is paid by funds rather than managed portfolios, the approach via MiFID II instead of UCITS and AIFMD, comes as an opportunistic initiative lacking the political agreement that would be necessary for it to be taken. We consider inadequate to pre-empt an industry change through the back-door, via a legislation that only concerns a small portion of the business.

Moreover, the timeframe given to ESMA to provide level 2 measures on MIFID and MIFIR is not compatible with the necessary period of assessment and consultation between regulators and the industry, such a dramatic change in the industry economic model requires. A lot of issues have not been yet assessed. For instance, MIFID II does apply to all asset classes such as fixed income, commodities, and foreign exchange. No analysis has been carried out on the potential consequences of ESMA's proposal on these classes of assets.

➢ *ESMA does not have the mandate to regulate on research*

It must simply and factually be noted that:

- nothing at level 1, including in the Commission's empowerment (cf. below), indicates that level 2 measures should be developed on research.
- nowhere in MiFID II is investment research mentioned except in Annex I, which lists it as an ancillary service

Moreover, recital (74) of MiFID II shows that restrictions on inducements are predominantly viewed from the angle of the distribution and placing of financial products to clients, i.e. the purpose is to avoid firms being improperly influenced in their investment decisions by receiving and retaining benefits from product providers and issuers: "*in order to strengthen the protection of investors and increase clarity to clients as to the service they receive, it is also appropriate to further restrict the possibility for firms providing the service of investment advice on an independent basis and the service of portfolio management to accept and retain fees, commissions or any monetary and non-monetary benefits from third parties, and particularly from issuers or product providers*".

➢ *Research is not an inducement*

AFG and AMAFI disagree that investment research could be treated as an inducement. The firm does not take advantage of a non-monetary benefit (research) at the detriment of its clients' interest, as there is no interest for the firm in obtaining that information other than to use it to develop its investment decisions for the management of its clients' portfolios. **In other words, this is not a "*benefit*" that the firm receives and retains for itself but a service that helps the firm makes its investment decision for the benefit of its clients**. In addition, research is not a service that is free as it is paid by the way of broker commissions.

A parallel could be drawn between investment research and the service of execution: they both are services received by the firm from a third party and paid by its clients, which does not turn them into inducements by the mere fact that it is not the firm that pays for them. Similarly, other services offered by firms are not explicitly invoiced to clients even though they can be value-added for clients, such as for example, confirmation or settlement services embedded in brokers' activities. This does not make them inducements. AMAFI therefore considers that investment research is not an inducement as defined in Article 24 of MiFID II, i.e. a "non-*monetary benefit*" provided to the firms "*in connection with the provision of an investment service or an ancillary service*" because it is simply not a benefit.

**Extracts from the Commission's request for advice (mandate)
and the Commission's empowerment for adopting delegated acts**

Commission's request for advice to ESMA

"*ESMA is invited to provide technical advice on*

- the conditions under which investment firms providing investment advice on an independent basis and portfolio management fulfil the requirement to not accept and retain any monetary or non monetary third party fees commissions or benefits as well as on the definition and conditions for acceptable minor non-monetary benefits; "

Commission's empowerment for adopting delegated acts with respect to inducements

Article 24 paragraph 13 of Directive 2014/65/UE

"*13. The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to ensure that investment firms comply with the principles set out in this Article when providing investment or ancillary services to their clients, including:*
(a) the conditions with which the information must comply in order to be fair, clear and not misleading;
(b) the details about content and format of information to clients in relation to client categorisation, investment firms and their services, financial instruments, costs and charges;
(c) the criteria for the assessment of a range of financial instruments available on the market;
(d) the criteria to assess compliance of firms receiving inducements with the obligation to act honestly, fairly and professionally in accordance with the best interest of the client."

The adverse economic impact of the proposal is plain

Would this regime change happen, AFG and AMAFI consider the consequences would be heavily detrimental for the business model of financial intermediation and consequently negative for the financing of the economy, especially on the SME segment. This would also put at a great disadvantage the jurisdictions where it is introduced, and would orient the asset management industry towards riskier activities.

➢ *A weakening of financial intermediation threatening the financing of the economy, especially for SMEs*

It is likely that **managers will be prevented from fully passing the added costs onto clients** because of the pressure on fees they face, triggered in particular by the current shift of the industry towards index funds. This will cause a reduction in the use of research and an additional barrier to entry into fund management (for the development of internal research or for having the capacity to bear the cost of research), at the detriment of investors' interest for a wide choice of providers.

Independent brokers and research houses that still exist on the equity markets will be put at risk of disappearing, restricting further the universe of professionals covering **SMEs,** and local businesses and making the latter less visible to investors. **Above all, the end result will be detrimental to SMEs, at a time when their participation in the European growth requires facilitating their access to market funding and in contrast with the stated political will of fostering their development.**

Only the larger players with international businesses, for whom coverage of these companies is relatively unprofitable, will be able to bear the cost of producing research, offsetting its costs through their other activities. The end result will be further concentration of the dealers industry into a cartel type of large international firms, less coverage of mid/small cap companies, higher costs to funds and a concentration of the asset management industry, with an advantage for asset managers with a US franchise.

➢ *A competitive disadvantage*

At a time when the fund management industry is globalising, it would put the **EU at a major competitive disadvantage compared to the US** where it does not appear that there is a debate on changing the way research is paid for. Using external research paid for by commissions as before, the US industry will be able to face lower costs and charge lower fees than their EU counterparts. In this context, it is likely that US firms with European business would move the management of their funds to the US or at least would concentrate the information content in the US with onward feed to their EU arms. As for EU firms with businesses in the US, they would be at a severe competitive disadvantage because of their detrimental cost structure. Finally, managers would be more likely to invest outside of the jurisdictions where this new regime would be applicable and to see their choice of investments reduced across them, in contrast with investors' interest.

➢ *A shift of asset management business towards riskier activities*

The trend favouring passive management exacerbated as the cost differential between managed funds and index funds will be further heightened, which in turn increases the systemic effect of the industry, such index funds being by nature pro-cyclical. This evolution does not seem desirable from a risk perspective. While the regulators try to supervise more carefully the financial markets so as to limit the systemic risk, we doubt whether such a trend in the asset management business, with all the herding behaviour it can foster, should be encouraged.

Appendix 2
French regulation

Extract of the AMF General Regulation: Book 3 – Service providers.

Article 314-79

All fees and commissions paid by clients or by collective investment schemes for transactions in portfolios under management, with the exception of subscription and redemption transactions relating to collective investment schemes or investment funds, shall be trading costs. They include:

1° Intermediation costs, taxes and duties included, charged directly or indirectly by third parties that provide:

a) Order reception and transmission services and order execution services on behalf of third parties referred to in Article L. 321-1 of the Monetary and Financial Code;
b) Investment decision aid services and order execution services specified in an AMF Instruction;
2° If applicable, a turnover commission shared exclusively between the asset management company and the custodian of the scheme or the custody account keeper for the portfolio under management.

Article 314-81

Asset management companies may enter into written commission-sharing agreements under which the investment services provider providing order execution service shares the portion of the intermediation fees that it charges for investment decision-making aid services and order execution services with the third party providing such services. Asset management companies may enter into such agreements, provided that the agreements:

1° Do not violate the provisions of Article 314-75;
2° Comply with the principles referred to in Articles 314-82 and 314-83.

Article 314-82

The intermediation fees stipulated in Article 314-79 shall pay for services that are of direct interest for the clients or the collective investment scheme. Such services shall be covered by a written agreement subject to the provisions of Articles 314-59 and 314-64.

These fees shall be assessed periodically by the asset management company.

If the asset management company uses investment decision aid and order execution services and if the intermediation fees for the previous year came to more than EUR 500,000, it shall compile a document entitled "Report on Intermediation Fees" that shall be updated as needed. The report shall specify the terms and conditions on which the asset management company used investment decision aid and order execution services, along with the breakdown between:

1° Intermediation fees related to order reception, transmission and execution services;
2° Intermediation fees related to investment decision aid and order execution services.

The breakdown for applying costs shall be formulated as a percentage and based on an established method using relevant and objective criteria. It may be applied to:

1° Either all the assets in a specific collective investment scheme category;
2° Or all the assets that the asset management company has under management for a specific category of clients ;
3° Or any other procedure suited to the method used for applying costs.

AMF Instruction n° 2007-02
Investment decision and order execution support services
(Reference texts: AMF General Regulation articles 314-79 and 319-14)

Single article - Investment decision and order execution support services

Investment decision and order execution support services must meet the criteria set out in articles 314-82 and 314-83 of the AMF General Regulation1; they include, for example, all economic research and financial analysis services.

However, the following, in particular, are not considered to be investment decision and order execution support services:

1° portfolio valuation services
2° purchase or rental of computers
3° payment for communication services, such as electronic networks and dedicated telephone lines
4° seminar registration
5° subscription to publications
6° payment for travel and entertainment
7° payment for computer software, particularly order management systems and office administration software, such as word processing and accounting programs
8° membership of professional associations
9° purchase or rental of offices
10° payment of employee wages
11 provision of public information
12° direct cash payments
13° financial instrument custody and administration services.