Investment Management Association

ima

Use of Dealing Commission: Corporate Access/Research Services

Purpose

The IMA today publishes this communication to assist its members in meeting the requirements of the FSA's rules on the use of dealing commission to pay for research and how that relates to the subject of corporate access.

The IMA has received comment from its members, from AIMA and AFME and other interested parties on a draft communication published in February 2013. This paper reflects those comments relating to the Dear CEO letter that might assist asset managers to demonstrate a wide range of competitive approaches within a compliant framework for the benefit of their clients and to minimise legal and regulatory risk.

At the end of this paper the IMA provides more detail on its intention to embark on a wider programme of work during 2013 to consider the challenges faced by asset managers in accessing bundled services, in valuing research so provided, and also in relation to corporate access.

Background

Asset managers must always act in the best interests of their clients. For many clients and managers, one aspect of this overarching aim is to achieve good outcomes from equity investments over the long run; another is to participate in the stewardship of the companies in which such investments are made.

Direct engagement with investee companies is part of the methodology of some asset managers and is deployed to promote the interests of clients by helping the manager to determine whether to buy, hold or sell any stake in a company. It does not however necessarily relate to the company held.

Additionally, for some years UK Government policy has looked to increase engagement of long-term institutional investors with issuers. Further work by the IMA will include how market changes arising from the Dear CEO might interact with the goals of the UK Stewardship Code.

But corporate engagement is by no means the only legitimate investment strategy used across the range of UK asset managers and clients; and where it is not it is likely this paper will be of only limited interest.

While many companies provide asset managers with access to their management team directly, and will also visit the asset manager as a valued shareholder, or potential shareholder, this access is not always readily obtainable. Member comments support the view that restrictions occur particularly, but not exclusively, in overseas markets. More comment has been expressed that such access is reserved or prioritised for the larger asset managers, who represent existing or potential investment of significant size.

Accordingly, a commitment to an investment model that is fed by interaction with issuers is sometimes met with barriers to engagement, either absolute or discriminatory, based for example on the size of investment or prospective investment. The value gap between the perceived benefit of corporate interaction and the cost of obtaining it has created demand for

Investment Management Association is a company limited by guarantee registered in England and Wales. Registered number 4343737. Registered office as above.

corporate access which can be satisfied in exchange for payment to third parties who can obtain and arrange access.

The arrangement of "corporate access", as it is loosely known, is an activity principally located within equity sales and (to an extent in the UK) corporate broking businesses of brokers. By virtue of their relationships with issuers and by making arrangements for several asset managers to visit issuers collectively, these brokers now intermediate corporate access for a significant number of asset managers and investors. This provides a benefit to issuers as well as to those asset managers who might otherwise not have easy access. Indeed an overarching reaction amongst asset managers to the Dear CEO letter is to reiterate the benefits that can accrue to clients from pursuing corporate access.

The bundled nature of services provided by major brokers means that corporate access is not generally invoiced or itemised with a cost line. Where payment for these services by the buyside is to be made through the use of dealing commission, any such payments, in addition to satisfying overarching rules on best interests, must specifically meet the requirements of COBS 11.6 "Use of dealing commission"[1].

This communication provides no critical comment about the commercial decisions made at asset managers about paying for any form of corporate access. Some may decline, preferring to rely on an issuer's appetite to see them or else be prepared to forego some meetings. Others may decide to pay otherwise than from dealing commissions.

Decisions to pay by means other than from dealing commission may result in payment by the manager or by one or more clients. This paper does not address the forms in which clients may be recharged costs of corporate access; for example the IMA understands that many hedge funds may contractually reserve the right to charge different types of expense to the fund in addition to dealing commission. So whilst this paper may assist with determining whether the cost of an activity characterised as corporate access may be paid, in a manner compliant with the FSA rules, out of dealing commission, it does not address how such a cost might otherwise be allocated between a manager or a fund when through choice or regulatory obligation it cannot be paid out of dealing commission.

It has been suggested to the IMA by a respondent to our public communication that some relationships, especially with prime brokers, may generate revenues other than dealing commissions, with examples given relating to revenues arising from the provision of margin for leverage or securities lending. IMA provides no opinion as to whether the examples given could properly be characterised as not being dealing commission. It should be noted that the use of dealing commission rule applies, amongst other things, to any services given to an asset manager in return for the charges which arise from carrying out an instruction given by an asset manager to effect a trade for a client.

New FSA Approach

The FSA references, in a letter placed in the library of the House of Commons, the Thomson Reuters Extel 2012 Survey as showing that corporate access accounts for 29% of dealing commission. The figure had not been supported by anecdotal information from IMA members with whom IMA has spoken, appearing very large compared to the experience of these

[1] The practice is not limited to the UK, for example the US SEC have included meetings with corporates in permitted expenditure from dealing commission (strictly as allowable under Sec 28(e) Securities and Exchange Act 1934). We address the international impact later.

members. We are very grateful to Thomson Reuters (TR) for providing IMA with the analysis of the Extel 2012 Survey.

In Extel 2012 TR collected data on allocation of commissions/what the buyside actually values and pays for in overall research and advisory services through a variety of questions. As such, TR ended up with two elements of data – one that had corporate access at 29% and one at 27%. The figure TR believes to have real validity is the 27% number (as this is based on a substantially greater level of feedback and response). It comes from over 4,200 buyside individuals, mainly portfolio managers, who responded to the question "What do you actually reward in sellside research & advisory services?".

The Table below shows the breakdown for the UK and globally.

What do you actually reward in sellside research & advisory services?

All numbers in %	UK Buyside View 2012	All Market View 2012
Independent thinking	17.6	17.1
Direct analyst contact	16.2	15.8
Corporate Access	15.4	15.2
Ongoing client/sales service	13.6	13.6
Trade ideas	13.4	13.5
Wide coverage of stocks	12.3	12.9
Expert panels/networks	11.5	11.9

The 27% is derived by adding together the specific 'Corporate Access' line together with 'Expert Networks' line. TR combined these as it took the view that the provision of experts falls in the broader definition of corporate access. this reflects the difficulties in determining what is understood by respondents by the term corporate access. In addition the survey does not seek to establish an explicit monetary value on Corporate Access as paid by the asset management firms themselves to brokers.

Whatever the figure for the attribution of dealing commission to corporate access at a firm level, the FSA is entitled to ask the asset management industry whether it can demonstrate that the current spend being paid for through dealing commission is being made in compliance with the FSA rules.

Trailed by comments at its 2012 Asset Management conference and in the press afterwards, the FSA issued a Dear CEO letter in November 2012. It purports to make no changes to existing rules or provide guidance. Its impact has, however, been very significant. A common

industry interpretation of the view taken in the letter on corporate access has been that it places the legitimacy of the purchasing of corporate access through the use of dealing commission under any circumstances into doubt. [That view has only hardened since the publication of the letter.] Industry reaction on both the buy-side and the sell-side reflects a widely held view that, if this is the case, it represents a changed, and narrower, interpretation by the FSA of existing rules compared with previous articulations. Sell-side brokers appear to have put some store in comments attributed to Hector Sants and their reading of the rules; asset managers additionally have many years of supervisory experience in which reviews of the use of dealing commission procedures did not challenge bundled payments which included corporate access.

For this reason we refer to the Dear CEO letter and subsequent reports of the FSA comments as "the new approach" to avoid needing to debate whether there has been a changed interpretation or changed behaviour. Accordingly the use of the term should in no way be taken to imply that some activities should not previously have been paid for through the use of dealing commission nor that pursuing corporate access itself may not be in the best interests of some clients.

But it does beg the question as to what is meant by corporate access. A particular challenge in addressing the Dear CEO requirements is that there is no specific description of the activities that the FSA considers may fall within its reference to corporate access. The IMA had hoped the FSA would provide more detail, but it acknowledges that the regulator does not have to do this if it is satisfied its rules are clear enough. The FSA states:

"Access to company management (sometimes also referred to as 'corporate access') means, in this context, the practice of third parties (typically investment banks) arranging for asset managers to meet with the senior management of corporations in which the asset manager invests, or might subsequently invest, on behalf of customers. It does not refer to any research services that might be provided by the third party alongside providing access to company management."

Whilst this provides some context it leaves open as to what constitutes research services provided "alongside" providing access. Some claim there is room for debate as to whether the full bundled service is within the rules when research services are bundled with, or are part and parcel of the same service as, access to management. The IMA does not intend by this paper to provide such comfort. That this may leave many asset managers on a different footing in the UK compared to other global financial centres is addressed further towards the end of this communication.

COBS 11.6: the position to date

The position of the FSA has been consistent at least as regards its view (which IMA paraphrases) that it is for asset managers to assess whether any payment can be recharged to clients through the use of dealing commission; and that firms should be able to demonstrate that they have made such an assessment and that controls are applied to ensure expenditure is in the interest of clients.

That throws the discussion back to COBS 11.6 which itself has rules, guidance and evidential provisions. One area which is particularly problematic given the new approach from the FSA is COBS 11.6.5E 1(d). At a meeting at UBS attended by the FSA in December 2012, IMA understands that asset managers recorded by a show of hands their uncertainty as to whether "meaningful conclusions" must be provided by the broker who arranges the corporate access in order for the service to qualify as research, or whether the fact that

information provided in the meeting enabled a portfolio manager to reach meaningful conclusions for themselves would be sufficient to qualify that meeting and the broker's work in arranging that meeting to qualify as research.

Many managers have informed brokers that they consider themselves unable now to pay for corporate access through dealing commission. The IMA understands that many will now ensure that corporate access is not a factor used in voting on how dealing commissions are allocated to brokers. A fear remains that brokers may still recover costs associated with corporate access through bundled content services; this is something that must be dealt with commercially.

The IMA expects during 2013 to assess potential changes to market practice that might address the engagement issue, and any barriers put up by issuers and their corporate advisers, and also the pricing and unbundling of research. The practical reality is that, in the current operating environment, brokers play a role in facilitating engagement. Asset managers wish to work with the FSA to ensure that the way in which they use broker intermediation to facilitate their engagement with issuers as a part of their research and stewardship activities should meet FSA requirements in their entirety.

The IMA wishes to stress that it is not proposing that corporate access should be charged for by brokers or issuers. This paper should not be used as an argument that it provides a rationale for managers to pay for some corporate access activities, notwithstanding a view submitted by AFME to IMA that "free" services may constitute inducements to trade or give rise to conflicts of interest in determining which brokers to use for execution services. IMA accepts that managers remain bound to determine which brokers they use on the basis of a series of factors, principally as detailed in the rules commonly referred to under the heading Best Execution. [It does not follow that an asset manager which complies with the requirements of COBS 11.2 in selecting and using brokers for execution services must decline corporate access opportunities which are provided without cost to it or its clients.]

Recommendations

IMA, in order to assist its members in complying with the new approach, makes recommendations without suggesting they are the only way to comply:

1. As noted above, where a broker is involved in corporate access, it may be acting as agent of the corporate, including those who are, for example, broker clients in an IPO. In other cases the broker may be acting on its own account, on behalf of one or more managers, or acting jointly on behalf of a manager and the corporate. There should be clarity as to the capacity in which the broker is acting and brokers could be asked to provide that information to allow the manager to determine the nature of the services and their monitoring obligations, including in relation to the use of dealing commission.

2. A manager should enquire as to how (if at all) the broker is remunerated for their services in this area. For example, it is presumed that deal roadshows are funded by the corporate but the position should also be made clear to managers concerning non-deal and reverse roadshows. (Although client commission spend has the potential to form a part of this remuneration of brokers, there will often be no transparency from the broker as to the actual pricing of the components of bundled services covered by that commission. It can be very unclear what the pricing position is around the various elements of bundled brokerage, including activities relating to company access, and the negotiation of prices can be difficult.)

3. Managers need to ensure that they are doing the best that they can in negotiating as competitive commission rates as possible for their clients. Clients can be expected to challenge managers if they feel that commission rates are higher than their expectations. The IMA disclosure codes provide detailed information for clients in this respect.

4. Managers would look at three elements:

    a. Clarify the position of the brokers in relation to their capacity and compensation arrangements, for example, by undertaking a communication exercise with them;
    b. Review the process around permitted research services and company access;
    c. Continue to seek to drive best value in terms of commission rates with brokers.

5. Dealing with (a) and (b), any letter to brokers should seek clarification that where a broker coordinates a corporate roadshow, so that a company management is brought in to see an asset manager, or a manager attends such an event, as to the capacity of the broker. The broker may be acting as an agent in the interests of[2] the corporate. Consequently managers would not expect to be charged for that meeting. More importantly managers would not expect dealing commission to be used to fund any such meeting. In the unlikely event that the broker was to seek to charge for this, they would need to invoice the asset manager directly for such an administrative service in this regard if it is to be paid for by the manager.

6. For some, any communication to brokers might also emphasise the asset manager's expectation as an institutional investor that it would desire continued "fair" access to companies. Asset managers may wish to write in similar terms to any issuers to explain their position. IMA may at a later stage consider what different managers may consider as fair; certainly access which discriminates on the basis of expected trading volume (and so more of benefit to the broker) as opposed to the possible longer-term benefit of an engaged shareholding (and so more of benefit to corporate and shareholder alike) may be a factor some managers may wish to reflect.

7. It is a separate matter for the broker to reconcile any conflicts with its corporate clients in terms of to whom it gives a one on one meeting, and whether it is otherwise remunerated for this via deal flow or other fees. This matter is for the sell side, not for managers to deal with.

8. The activities which might relate to corporate access will commonly fall into one of three scenarios:

Scenario A: where a broker brings a company in to see a manager as part of a non-deal roadshow, as described above, the asset manager would not expect to be charged for this, or if there was any charge, it would be for the manager or client to settle, not for payment to be made out of client commission.

---

[2] Of course, it may be that the broker is only acting in its own interest, neither for the corporate nor the managers. The range of relationships, the nature of a corporate's oversight of the process and the alignment of incentives where the corporate has consented to the broker obtaining reward for introducing managers to the corporate will likely be considered in other work by the IMA.

Scenario B: where the asset manager proactively approaches a broker to help arrange a trip or give access to specific companies, and that broker, makes the necessary arrangements, i.e. effectively acting as "travel agent" or arranger, then the manager may agree with the broker to be charged for the broker's services. The approach of the manager may include paying for expenses or fees in making these administrative arrangements, or ascribing another value determined on the manager's own criteria. This would not be paid for out of client commission: COBS 11.6.8G(6) appears relevant.

Scenario C: where the asset manager asks the broker to provide a more bespoke service where there are value added services provided by the broker, e.g. analysis of a sector or industry to identify key players and potential people to meet, or participation in a road trip by the relevant broker analyst to provide colour and input to the trip and their insights, this engagement (or at least a part of it) could be a permitted research service. It would be for the concerned individuals at the asset manager to make an assessment of the services in terms of the four-point test in 11.6.5E. Given the particular issues now facing the industry, this approach could be reviewed if the FSA provided greater clarity on the precise meaning of COBS 11.6.5E 1(d) but to date no indication has been given that this might occur.

Some criticism was made of Scenario C in the open consultation as it reads as if the four components of COBS 11.6.5 define exhaustively what can constitute research such that if they are not met then any service or goods could not be research. IMA acknowledges that the four components are part of an evidential provision and that if they are present it tends to evidence compliance with the rule, and that conversely the absence of all four does not evidence a failure to comply. FSA referred to this balance of undefined rule references and evidential provisions as a principles-based approach (see for example paragraph 2.3 of PS05/9) and that this was appropriate given that "investment managers are best placed to assess whether, within the regulatory parameters, it is appropriate to pay for a particular service with commission". Given the Dear CEO letter, beyond noting the legal difference between a rule and an evidential provision, this communication proceeds on the basis that all four conditions need to be met.

Managers will wish to consider what processes they will need to allow the firm later to demonstrate that the engagement, or a portion of it, was capable of payment out of client commission.

In the meanwhile IMA understands some firms will take a conservative view of evidential rule 1(d) such that if a sell-side analyst is not present and adding research value in a meeting with company management, payment will not be made through dealing commission. Put simply, such firms read the rule as needing the person reaching the meaningful conclusions to be the broker analyst being rewarded and that it does not extend to rewarding brokers for arranging a meeting at which the manager carries out research notwithstanding the benefit that may accrue to clients from such activity.

The same principles would apply to broker conferences. Where the broker is acting in a capacity simply as a coordinator of an event, then there will be more grounds for this being paid for, if charged for, by the asset manager or allocated to a client otherwise than through dealing commission. But where there is evidence of the value added nature of the broker's involvement, for example where the broker has used knowledge and experience in pulling together a tailored program (and not just a pro forma agenda), facilitating certain sessions, and providing input and access to their own proprietary research, then it would be possible to attribute some value as a permitted research service (excluding, of course, on any basis any travel or accommodation or entertainment provided as part of the event).

These approaches will require very different invoicing methodologies by brokers so that even if services cannot be fully unbundled the value attribution is compliant with the use of dealing commission rules. IMA has been told that brokers do not invoice or that it would be very difficult to attribute a charge to specified activities. In the absence of this, it must be expected that many managers will feel unable to attribute any dealing commission to interactions with companies.

This paper does not address disclosure to clients. This must be made in accordance with FSA rules. The IMA Disclosure Codes require disclosures at Levels 1 and 2 (as the Codes call them) and the IMA is always available to assist firms with completion of the disclosures.

The international dimension

The Dear CEO letter has caused very considerable re-appraisals of the geographical impact of the FSA rules. Given the new approach appears to be stricter than in any major jurisdiction in the world, the extent to which global mandates can be operated practically from the UK has been questioned by some. The IMA is not commenting in this communication on the appropriateness of the UK having stricter approaches; that is a matter on which both Government and the FSA have decided. The FSA rules on dealing commission are in force not merely from a decision of the FSA, but also since 1 November 2007 from a decision of HM Treasury to notify the rules on behalf of the UK as being super-equivalent (gold-plated) applications of an otherwise pan-European approach to inducements. But any further consideration of the rules, their extent and the clarity with which they can be applied ought to occur in a context which fully considers the global reach of the UK's industry.

Given the new approach, many members have been re-assessing their activities carried out in the US market (in particular). The SEC approach to corporate access is more liberal than the new approach. Therefore where an instruction is given to a US broker which relates to a portfolio being managed on a client relationship basis by an FSA regulated asset manager, a firm has to determine which rules apply. If the FSA rules apply then the US broker would not be able for example to aggregate that order with orders from other clients if that may result in research credits being generated which were applied to corporate access as the SEC permits but outside the new approach used in the UK.

Paragraph 2.19 of CP05/9 refers to the jurisdictional reach of the FSA rules and notes they apply to investment management activity carried out in the UK and that the reach is no different from the rest of COB (as it then was). The provision is now at COBS 1 Annex 1 Part 2 para 2 and Part 3 para 3:

- Where a decision to invest is made in the UK and merely communicated through a branch or delegate to a US broker, it will be subject to UK rules.
- Where decision-making in exercise of the discretion given by a client takes place in the US branch of a UK firm, but the mandate from the client was given to the UK side of the firm, some take the view that the UK rules do not apply. Clearly this is a matter for legal advice, but IMA notes that if the FSA firm which has the client relationship receives benefit from the research service, then members will wish to ensure such advice reflects the purposive approach FSA takes to its rules.
- Where however a separate US entity has been appointed to carry out all management activity over the US part of a portfolio but the client is still only contracted to the UK firm then the position amongst members is more commonly that the UK rules do not apply (but much will turn on the true nature of the relationships and activities).

Members will wish to be sure they have clear advice on whether any international activity is not governed by FSA rules. This would be even the case if the FSA firm which has the client relationship receives no benefit from the research service. If the FSA regulated firm does, then given the purposive manner in which FSA will read rules and comments made by FSA in public meetings since the Dear CEO letter was published as to the wide extent of the rules, some members may choose a conservative approach in any event.

~~~

Conclusion

The IMA has published this paper to advance discussions in the market as to how best to identify and assess what can be paid for through the use of dealing commissions following the FSA's Dear CEO letter. It is not for the IMA to question commercial decisions within the boundaries of compliant behaviour and some firms will choose not to use dealing commission for activities that might be permissible under FSA rules.

The IMA recognises that many underlying issues relate to the structure of the research and corporate access markets; the IMA will commence work on these issues during Q2 2013.

27 March 2013
~~~