

The Use of Dealing Commission for the Purchase of Investment Research



About the IMA

The Investment Management Association (IMA) is the trade body for asset managers (retail and institutional) who manage £4.5 trillion of assets in the UK as at December 2012.

Our purpose is to ensure investment managers are in the best possible position to:

- 1 Build people's resilience to financial adversity
- 2 Help people achieve their financial aspirations
- 3 Enable people to maintain a decent standard of living as they grow older
- 4 Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs.

The UK is the second largest investment management centre in the world, after the US.

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Executive Summary

This report reviews the current market for the purchase of externally sourced equity research by investment managers in the UK, with a particular focus on what type of arrangement benefits clients most. It sets out a structured approach for assessing the governance of research procurement. Finally, it proposes opportunities to improve procurement processes and increase transparency to clients.

The report pays significant attention to payment for research by means of dealing commission, bundled with execution costs and paid out of client funds, which is the most common approach; and which can give rise to conflicts of interest. The report highlights ways in which investment managers (IMs) aim to ensure that they are as prudent in spending client money on research as they would be if it was their own.

The impetus for this report was to build on positive developments within the industry, as well as to inform the continuing regulatory interest in the topic. It is aimed at informing the full range of stakeholders. It includes recommendations for the market (Appendix 1) and actions that the IMA is undertaking on its own initiative (Appendix 2).

In producing this report, the IMA set itself the following four objectives:

- 1 Promote the optimisation of value for money, transparency and accountability for clients
- 2 Outline the characteristics of the existing model, its benefits and its challenges;
- 3 Continue to assist investment managers in ensuring high standards of conduct, in this instance by making recommendations on conflicts-of-interest management; and
- 4 Propose a set of eight measures, against which the overall benefits of any model for research payment, existing or prospective, can be evaluated.

“We propose a set of eight measures, against which the benefits of any model for research payment can be evaluated”

An integral part of the project has been to identify any benefits to clients that a) are inherent in the current structure and b) might be lost if it was to be radically altered.

Accordingly, as alluded to above, the report puts forward a set of eight criteria, against which to test the merits of any approach, whether that be the current approach or any alternative structure. This framework is intended for use by all stakeholders, including regulators and market participants. It is also relevant to the suppliers of research, particularly those who package it with execution. (See p.17, 'The Eight Measures of a Good Regime for Research Payments').

The report describes the processes adopted and implemented by asset managers to ensure fairness to clients, whether through the use of commission sharing arrangements (CSAs) or other models.

The report also makes a number of recommendations that could improve the current model, notably by optimising the effectiveness of budgeting and oversight.

The Investment Management Association (IMA) commits itself to undertake a number of actions, including a review of the IMA Disclosure Codes¹, to provide greater transparency and accountability to clients. In particular, the IMA is committed to make recommendations that would ensure disclosure of research spend to UK collective investment schemes, directly to holders of units in those funds and in a format that would be understandable by those holders.

The IMA (which itself has no regulatory remit) confirms its readiness to work with the Financial Conduct Authority (FCA), to explore constructively any and all possible new models for the purchase of research; to test any such model against the eight measures; and ultimately to help the FCA determine how well it would serve clients' interests, in comparison with the current model. The IMA sees no reason why this cannot be balanced with proper regard for the UK's international competitiveness (as reflected in the eighth of our eight measures of a Good Regime). This means change should be implemented on a global basis.

The report considers a potential new market structure under which dealing commissions would no longer be used for the purchase of research. It identifies a number of potential negative consequences from such a change, including: loss of international competitiveness for UK financial services firms (unless change is internationally co-ordinated); a major reduction in research coverage of small and medium-sized enterprises (SMEs); and the raising of a barrier to entry for Investment Management start-up firms, reducing competition and innovation that benefits customers. The extent of the impact of such changes would need to be assessed, as well as any ability to adjust to them.

If it is concluded that a new – and therefore global – model would be better than the current model, the IMA recommends strongly that the International Organization of Securities Commissions (IOSCO) be the co-ordinating body.

Comments and questions on this report are welcome. Please send them to Guy Sears: gsears@investmentuk.org

¹ See Section 2, subsection on Transparency, for more on the work on these Codes.

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Introduction

Members of the IMA make investment decisions from the UK in relation to nearly £1.9 trillion of equities belonging to collective investment schemes, pension schemes, life companies and other institutional clients².

IMA members, who have contributed to this report, range from the major global asset management firms to smaller boutiques and include every ownership model from partnerships to unlisted companies and from listed independents to bank- and insurer-owned firms. For many of these firms, investment management is an international business, in terms of client base and the investments made on their behalf.

For many managers, research is a key part of the investment decision process. That process connects the savings of millions of people globally to businesses both small and large, providing the capital that generates growth, employment and tax revenues.

This report focuses exclusively on externally sourced equity research and does not address either research generated in-house or credit research (where there are no dealing commissions and where the cost of both execution and credit research can be incorporated into bid-offer spreads). While conflicts management and value attribution may be issues in any sector, equity research raises specific questions, because of its payment mechanics and detailed regulatory requirements.

Externally provided research can come from a variety of sources: major investment banks, smaller brokers or a range of other businesses, some of them major distributors of information, while others are boutique research houses.

The cost of research is typically passed back to the client, alongside the execution cost of buying or selling equities. Globally, the IMA estimates that over half the total global investment-manager-directed expenditure on externally sourced research is treated in this way, as an extension of execution costs. The current regime, including the use of commission sharing arrangements (CSAs) by those whose business

models it suits, brings many benefits, including: flexibility over which suppliers are rewarded for the quality of their research; economies of scale; and breadth of coverage of companies. It also underpins a global procurement model that can be operated from the UK.

The use of dealing commission to pay for research can give rise to conflicts of interest between the investment manager and its clients. It can also give rise to conflicts of interest between various clients of the same investment manager.

The effective management of conflicts of interest is a fundamental quality that all investment managers should be able to evidence. Some criticism was levelled, in a 2011/12 review by the UK regulator, of aspects of the standards of care and control over research procurement. However it is important to note also the strong processes and significant commitment of human resources that are common in the industry, to ensure effective management of conflicts; as well as that the recommendations in this report are drawn from existing best practices in the industry, including enhancements introduced by the industry since that review.

This report does not aim to bring an end to the debate. It sets out to inform a wide audience (beyond IMA members and regulators) of the benefits and challenges of the current global model (as experienced in the UK). IMA members may find some of the information, particularly in Sections 1 and 2, quite familiar.

The report consists of three sections of analysis and two appendices, the first of them containing the IMA's recommendations for the market:

- **Section 1** ('Research and its procurement') describes the features and benefits of the current system.
- **Section 2** ('Challenges') focuses on the challenges of the current system, including the method of commission generation and the valuation of research.

² IMA (2013) 'Asset Management in the UK 2012-2013', p.11.

- **Section 3** ('Looking to the future') proposes the framework of eight measures against which the current regime and any alternatives might be assessed and compared, and examines the external factors impinging on the success of any reform process.
- **Appendix 1** makes 'Recommendations to improve current practice'. The recommendations are about budget-setting and governance and, if extended consistently across the whole industry, will support greater transparency in relation to investment managers' use of their clients' money to purchase research.
- **Appendix 2** lists the actions that the IMA itself intends to undertake.

Not all the recommendations in Appendix 1 will be new to every investment manager. Moreover, some of the possible improvement will depend on co-operation from suppliers of research.

The IMA itself makes commitments to look at further enhancements, especially in 1) benchmarking, 2) budgeting, and 3) conflict disclosure. Additionally, the IMA intends to review and, as appropriate, revise the type of information that is provided to all investors about research expense.

The report looks beyond the existing UK rules, to a possible global regime. It countenances a (global) market in which dealing commission was no longer used to pay for research. It also counsels that impacts from unilaterally introducing a national model – including impacts on international competitiveness and on research on SMEs – need to be thoroughly considered, when deciding whether such a change would, in sum, create a better outcome for investors.

The eight measures that the IMA has proposed (against which any regime can be rated) support the analysis referred to in the paragraph above. Accordingly, the IMA will encourage and support the FCA in its efforts to secure a global debate about research payments and the management of conflicts.

The research market does not consist solely of the investment managers, of course. The major research providers, commonly the global brokers, must play their part in ensuring the best possible model for customers.

The IMA would like to thank, firstly, those of its members who served on its working group; and secondly, the advisory panel which consisted of Glenn Bedwin (EuroIRP), Will Goodhart (CFA UK), Prof Tim Jenkinson (Saïd Business School), Steve Kelly (Thomson Reuters Extel) and Neil Scarth (Frost Consulting). The ideas in this paper remain those of the IMA and do not necessarily reflect the views or opinions of any other person.

The IMA would also like to thank the many dozens of individuals from banks and investment banks, the Association for Financial Markets in Europe, and the Association of British Insurers, as well as independent research providers, the FCA and some other individuals for their time and insights.

Why now?

Many of the issues that are a focus of attention today have been in existence for some time. Crucially, conflicts of interest can arise when a financial-services firm is paid to be responsible for looking after the interests of clients (particularly several clients), and investment management is no exception. UK regulation requires that such conflicts are either avoided or managed; and that clients are informed if they cannot be managed sufficiently. The use of dealing commission, paid out of client funds, to purchase research does give rise to potential conflicts. But (in line with the above) investment managers need to manage and control such unavoidable conflicts (as they do in practice, through a variety of measures).

Following the Financial Services Authority's (FSA) 'Dear CEO' letter in November 2012, related to a paper on conflicts of interest management, the IMA and some of its members investigated the current model for the purchase of research via dealing commissions. We i) considered how outcomes could be improved across the board, in part by sharing good practice; ii) explored alternative models; and iii) examined how further work might help to weigh up the benefits associated with any of these.

Meanwhile, the FSA's successor body, the FCA, has commenced work to determine whether to have a wider review of the current regime. In addition, the FCA has suggested that the revision of the EU's

Markets in Financial Instruments Directive (MiFID) might also impose constraints upon the use of dealing commission.

Use of dealing commission

Given the recommendations made in this report, it is important to understand what is meant by the use of dealing commission, which in turn requires a brief overview of the history of the subject.

In the 1970s, the majority of the world's leading stock exchanges by value were characterised by fixed commission rates, with a minimum level of commission charged by brokers. To differentiate themselves, the brokers responded by providing, or facilitating the provision of, a range of additional services and products to investment managers. Then, following similar developments in the US, Canada and Australia, minimum commissions in the UK were swept away by the 'Big Bang' of 1986. However, 'soft-dollar' arrangements for the purchase of research and other services (known as 'softing') continued.

In 2001, the consultancy Oxera estimated that £500-£720 million of clients' money expended was allocated to research provided on a bundled basis, ie, along with execution³. However, a further seven per cent of all commission spend by UK fund managers with UK brokers was paid back in softing (for various services – not just research⁴), equivalent to some £160 million of commission⁵. A quarter of that (ie, £40 million) was estimated to be attributed to research spend.

The Myners Report (2001)

Delivered by Paul Myners, 'Institutional Investment in the United Kingdom: A Review' ('the Myners Report') was prepared for HM Treasury in March 2001 and, amongst a broad range of other issues, considered the question of bundling and softing.

The Myners Report argued that standard market mechanisms presented a weak control on the total cost of these types of bundled and 'softed' services, as the lack of transparency and accountability in relation to commission costs made it difficult or impossible for customers to establish whether the investment manager was controlling conflicts of interest effectively, and was therefore delivering value for money to its funds. As it stated, "this system creates an artificial bias for fund managers to have services provided by the sell-side, distorting competition, since the costs for these will not be scrutinised by the client and are not a direct charge to the fund manager's profit. In effect, the fund manager outsources a business input to the sell-side with the cost charged directly to the client."⁶

“Improvement
will depend on
co-operation from
suppliers of research”

³ Oxera (2003) 'Cost-Benefit Analysis of the FSA's Policy Propositions on Soft Commissions and Bundling', p.45.

⁴ NB: much of that expenditure, eg. on portfolio valuation or custody, can no longer be expressed as dealing commission (viz. FCA Rule COBS 11.6): uses of dealing commission are restricted to the purchase of research and trade-execution services and analysis.

⁵ Oxera (2003) 'Cost-Benefit Analysis of the FSA's Policy Propositions on Soft Commissions and Bundling', p.21.

⁶ Myners (2001) 'Institutional Investment in the United Kingdom: A Review' p.96.

Introduction of the use of dealing commission rules (2006)

The Myners Report prompted action by the FSA, resulting in the publication of the consultation paper CP176 in April 2003. That consultation proposed a significant narrowing of the services that brokers could provide alongside execution; among these changes the consultation proposed that the value of all non-execution services should be rebated to clients or, alternatively, that services should be unbundled. Responses to the consultation, both by buy- and sell-side firms, resulted in the creation of the so-called 'use of dealing commission rules.'

The current rules for the use of dealing commission are to be found in COBS 11.6, part of the FCA Handbook of Rules. They state in general terms that, when a manager pays a broker for dealing services in relation to equities, payment can only cover research services directly related to execution (in addition to the execution of the trade itself).

The rules do not prevent the receipt of, or payment for, other goods or services, as long as dealing commission is not used. (Equally, the rules do not require research to be paid for solely through the use of dealing commission.) The rules apply to the situation where dealing costs are passed back to

the investment manager's client (eg. the pension scheme or unit trust), in such a way that the client is a) separately charged for each trade, and b) that charge includes a component to cover research provided by the broker or a third party.

There is also a requirement to make disclosure to the clients on an initial and periodic basis. In order to comply with this, much of the market uses the IMA Disclosure Codes.

As a result of CP176, from July 2006, UK investment managers were required to separate out internally the dealing commission applied for research from the dealing commission applied to the execution. Despite this internal disaggregation, the payment remained bundled, reflecting the fact that the service from brokers itself remained bundled.

It is notable that the rule only applies to equity trading⁷, where the charge made by the party organising the execution is expressed as a commission on top of the price. Fixed income markets trade predominantly on spread and the cost of any credit research is bundled into the spread. It is worth reiterating that this report limits itself to discussions relating to equity trading, unless otherwise made clear (and even if payment for credit research may itself raise conflicts).

⁷ Shares and (a) warrants; (b) certificates representing certain securities; (c) options; and (d) rights to or interests in investments of the nature referred to in (a) to (c); to the extent that they relate to shares.

Section 1: Research and its procurement

Following the November 2012 'Dear CEO' letter, the FCA is now conducting a thematic review of the market(s) by which research is provided to investment managers. It is important therefore to place the present debate in a context, to identify where improvements could be made and to ask whether the characteristics of the current market and any positive features of it could be better delivered through a different market model.

Members of the IMA report very little interest in the subject historically by most clients. The reason for this may well be the fact that commission spend is in practice overshadowed by other costs. So, while it may amount to a measurable number of basis points of cost, the greater impact of significant accounting shortfalls (in the case of pension schemes), a low-return environment more generally and concerns (again, in the context of pension schemes) over sponsor covenants, may serve to explain its relative position on institutional clients' agendas. Nevertheless, investment managers accept their responsibility to address areas where improvements can be made that benefit clients, even where there is little pressure from clients or a relatively low cost impact on a per-client basis.

The procurement and consumption of research is at the heart of many investment approaches. Research can take a variety of forms, including but not restricted to written notes and ideas available to all, bespoke reports and calls, and face-to-face meetings with analysts.

This report identifies three broad sources of research that is aimed primarily at investment managers:

- 1 Investment managers' own in-house research capability;
- 2 Full-service brokers which provide both research and execution services; and,

- 3 Other third-party providers, commonly referred to as 'independent research providers' but which also include vendors of data products. The group is commonly, but not exclusively, characterised by not providing execution services.

Investment managers source research from all three, but the level of reliance upon one or more of the three groups varies by firm.

Additional sources of research include industry and trade journals, consultants and expert networks. While these may not have investment managers as their primary target, the information they provide may assist portfolio managers in making investment decisions (although subscriptions to journals do not meet the definition of research that may be paid for from the use of dealing commissions).

The size of the market is difficult to ascertain, but what is clear is that research is paid for in a variety of ways:

- a) In-house research capability is funded from an investment manager's own financial resources, just like any other department.
- b) In equity markets, full-service brokers receive most of their payments for research through the use of dealing commission, whereas in fixed income markets, they fund their research provision from the (bid-offer) spreads charged by their market-making arms.
- c) Independent research providers may receive payment direct from the investment manager against an invoice for one-off pieces of work or for a subscription service. They may also, in whole or in part, be paid from dealing commission in a similar fashion to the full-service brokers through the use of CSAs.

Definition of ‘research’

Presently, the FCA rules do not exhaustively define what constitutes ‘research’. In the most general sense, there has never been a need for a definition. An investment manager under UK and EU rules is required to act honestly, fairly and professionally in the best interests of its clients. This is the first ‘filter’ to be applied to the procurement of any service, including any form of research, where the cost may be borne by the client.

The only reason why the FCA rules need to provide any definition at all of the term ‘research’ is the existence of the rules (introduced in 2006 and mentioned in the Introduction) on the use of dealing commission.

The decision not to define ‘research’ was deliberate when those rules were introduced as the regulator considered that managers were best placed to determine the services that qualified.

However, a recent FCA consultation paper (CP13/17) on the use of dealing commission proposes several changes, or clarifications, to the rules. (This report presumes the changes proposed in CP 13/17 will be adopted, at least for the most part, but it applies just as much if they are not.)

The proposed new rules include guidance in the form of a list of services that cannot amount to research (eg. raw historical trade data).⁸ It is also proposed that services for arranging corporate access should not count as ‘research’.

The rules currently include four evidential tests that, if met, give reassurance that the research is eligible for payment through the use of dealing commission. The proposed changes shift the emphasis, from evidential rules to obligation. The four characteristics would have to be present for any good or service to qualify as ‘substantive research’⁹. Specifically, it must be ensured that a good or service:¹⁰

- a) Is capable of adding value to the investment or trading decisions by providing new insights that inform the investment manager when making such decisions about its customers’ portfolios;
- b) Whatever form its output takes, represents original thought, in the critical and careful consideration and assessment of new and existing facts, and does not merely repeat or repackage what has been presented before;
- c) Has intellectual rigour and does not merely state what is commonplace or self-evident; and,
- d) Presents the investment manager with meaningful conclusions after analysis or manipulation of data.

Currently, it is open to an investment manager to argue that another service, as long as it is not on the list of banned services, constitutes research. The proposed changes appear to close off this possibility in the future.

‘Mixed usage’

Under CP13/17 the rules will permit payment for a service which bundles research with other, non-execution non-research services (eg. subscription to a sophisticated data service or corporate access services). Part of the service may meet the evidential test, while another part may be in the list of prohibited usages, such as post-trade data or corporate access services. In such a case, a mixed usage calculation may be carried out to attribute cost to the permitted research and ensure that only that portion is paid by the client.¹¹ The new rules, in other words, propose to reinforce the requirement to disaggregate mixed use services.

Prior to the debates over corporate access, mixed usage calculations commonly related to sophisticated data services provided by businesses such as Bloomberg. As part of mixed usage, the rules required an investment manager to attribute a value to the allowable components, using an approach which

⁸ COBS 11.6.8G.

⁹ FCA’s new term for research that can be purchased with dealing commission.

¹⁰ COBS 11.6.5E.

¹¹ The basis on which that value is attributed and the question of whether there should be a measurement of the value received by the investment manager are areas for consideration by the IMA as part of the usual good practice discussions with its members.

is honest, fair, professional and in the best interests of the clients. (The proposed change makes this more explicit.) Mixed usage approaches were not universally applied by the investment management industry and many managers would pay for the entire service from their own financial resources. This would reflect both the cost and complexity of performing mixed usage calculations and a firm's approach to applying the rule. To create a level playing field in the industry, a sensible methodology for mixed use calculations will be required.

Paying for research through dealing commission

When trading equities, an investment manager's primary aim is to achieve best execution for its client. A transaction will typically generate a dealing commission payable to the executing broker, which may be related only to the execution service or may additionally contain an element that represents a payment for (allowable) research services.

By way of example, a manager may agree to pay a broker a rate of 7bp¹² for execution and – maybe irrevocably, but possibly subject to later, performance-related reallocation, via a CSA, to *another* research provider – 8bp for research. (The numbers used are purely illustrative and indeed rates vary significantly, by geography and the amount of business an investment manager can offer a broker.) Orders to buy or sell equities are placed by the manager with the broker chosen for best execution purposes, and the broker will know by prior agreement (or notification) that the order is for the bundled rate of 15bp (albeit with 8bp possibly subject to later reallocation).

In practice, there are two broad ways in which this basic process is used to pay for research: the 'bundled' model and the CSA model, the latter relying on a 'research vote', while the former may make use of one.

The bundled model

In this model, full-service brokers charge for research by means of a set rate per executed transaction. In practice, of course, a manager may trade with a number of full-service brokers at their respective bundled rates. Each broker will provide research to the investment manager as part of their service. Each broker will over a certain time period, say three or six months, be used because they can offer best execution. As will be explained below, the total payment to any one broker over a set time period can in practice be capped by the investment manager, by switching to 'execution-only (XO)' rates for transactions.

If research is required from other parties, the investment manager can buy that research from its own financial resources, although some smaller managers may rely almost exclusively upon research from full-service brokers.

Good management oversight will aim to prevent the decision to direct trades to any particular broker for execution being unduly influenced by a desire to reward that broker for the research it supplies. This is further explained below.

The CSA model

In this model, the investment manager enters into an agreement (the Commission Sharing Arrangement) with each full-service broker that it chooses to execute with. This differs from the bundled model above as the CSA provides that the full-service broker retains all or part of the research payments in a separate book, for three or six months typically. The amount thus accrued over time can then be paid out periodically, as directed by the investment manager, to any research provider, whether that is to the broker holding the moneys, or 'paid away' to another broker or to an independent provider of research that offers no execution services.¹³

As an example, assume £1 million of shares are purchased by a broker on behalf of a pension scheme, having received instructions to do so from an investment manager. The settlement instructions

¹² 7/100 of 1%.

¹³ This feature is a consequence of the post-Myners Report reforms and was permitted by the regulators in the hope of invigorating the market for independent research to the advantage of clients.

passed to the custodian for the pension scheme require it to send £1,001,500 (£1 million plus 15bp) to the broker's account. (Taxes and exchange fees are ignored in the example.) The broker takes the £700 execution fee for itself and credits the further £800 to a research pot. This £800 is then available to be spent on research that meets the FCA's rules. Of course, the total research pot will comprise the credits from many trades, and it therefore has the potential to amount to a significant sum over time, especially in the case of larger investment managers.

The credits placed into the research pot will come from a range of different clients. Thus several defined benefit (DB) pension schemes, local authority pension schemes, other institutional clients and authorised funds may have contributed payments to the same research pot based upon the value of their trading activity. The manager is then able to make payment¹⁴ for research, in its various forms, taking into account the benefit for its various clients.

To the extent that research service is provided by the broker's organisation to the manager, the research fee is retained by the broker; for research services provided by a third party and paid for via this CSA, the research fee is transferred to that party from the account held with the broker (also referred to as 'pay away').

As with the 'bundled' model, the investment manager can cap research expenditure in any one period by switching to an XO service.

Research vote

Even where, historically, the total research spend in any year has been highly correlated to the aggregate trading value, the use of CSAs has meant that the allocation of any portion of research spend to a particular full-service broker provider has not needed to reflect the level of trading effected with that particular provider. How then does the allocation of the research commission occur? Where CSAs are used,¹⁵ the industry typically follows a process often referred to as

the 'broker vote', although this report refers to it as the 'research vote' as that is more apposite.

The research vote is a process by which an investment manager determines how to allocate research commissions that it has generated through trading. Importantly, investment managers also use the output from the vote, including qualitative elements, to communicate feedback to research providers on their service. In the absence of a transparently priced supply, therefore, there is a range of practices that essentially seek to capture what individual portfolio managers value.

Through the research vote, the investment manager is able to say to a given provider what it wants to pay for a service delivered regardless of the provider's own perception of its value. This is particularly the case where the research vote is designed to permit the individual investment managers to allocate to each provider a specific monetary amount. This contrasts with the more common model of percentage payout, where the vote allocates to each provider a percentage of whatever pot exists.

Best execution

The use of dealing commission necessarily implies a prior execution of trades. When placing orders, investment managers are under a duty to act in the best interests of their clients, commonly thought of as 'best execution'.¹⁶ The conflict between the duty to obtain best execution and the desire to generate a particular level of research commission at a broker risks distorting the direction of trades in favour of particular brokers by linking the payment for research with trade execution, although this can be mitigated by the use of CSAs. While execution cost is always important, it is only for retail clients that it is the determining factor in achieving best execution.¹⁷ In all other cases, the investment manager has the flexibility to subordinate cost to other factors such as execution quality,¹⁸ if that is believed to be in the client's interest. The incorporation of bundled research complicates matters.

¹⁴ It should be noted that, for convenience, the report uses the terms 'make payment' and 'pay' interchangeably whereas 'make payment' would be the appropriate term. This is because, in one sense, the manager does not pay for the research – the research is paid for by the client while the manager merely rewards its provision. This is the principal source of conflict which the use of dealing commission rules seeks to constrain.

¹⁵ This is not exclusive to CSAs, and can also be seen with bundled models.

¹⁶ While, in technical terms, this does not equate to best execution under EU law, it is indistinguishable from it in practice.

¹⁷ COBS 11.2.7R and 11.2.8G.

¹⁸ Under COBS 11.2.1R a firm must get the best possible result having regard to price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of an order. Good quality execution will seek to minimise market impact, for example.

Best execution and bundled trading

Where an investment manager trades 'bundled' with only a small number of brokers and only receives research from them, it is more challenging for it to generate the right amount of research payments at each broker while avoiding best execution distortions.

For that reason, some investment managers use their own financial resources to pay for third party (non-broker) research. The model operates along the following lines:

- The investment management firm operates with a complete separation of functions between a) the decision to buy or sell and b) the duty to seek best execution. The latter is driven by its trading department, with discretion as to which execution venue can be used for any particular order;
- Where there is no research element to the trade (i.e. what is being done for the client does not demand research input), there is a proper consideration of the relative execution merits of the full-service brokers and of alternative trading venues such as crossing networks, algorithmic trading and execution-only services;
- Research providers are only utilised on a bundled basis where the investment manager is able to meet its best-execution obligations. Thus, an investment manager might rank brokers by quality of trade execution (as an adjunct to its research vote); but with the threshold condition that their execution is competitive with that of other brokers not on the list;
- Budgets are established and managed for third party research services that are paid for by the investment manager out of its own resources; and,
- There is clear governance and oversight of the entire process.

Best execution and CSAs

As discussed above, use of a CSA can be a way to address this potential for bias in order direction.

To facilitate some CSAs between brokers and managers, there are third-party providers of related administration services.

Comparison of existing models

As mentioned, the CSA model generally depends upon a research vote to allocate reward.¹⁹ Equally, the IMA has had thoughtfully governed models described to it which do not use CSAs. Of course the general approach of the investment manager is often a key determinant of how clients' interests are protected.

In all cases, the bundled supply from full-service brokers introduces challenges for investment managers when it comes to valuation, but there are some key controls which, when implemented, should bring about real improvements for clients.

Budget-setting

The FCA recorded its view of good practice as including the situation in which a manager "set a maximum spend on research services and, once these limits were reached, switched commission rates for the brokers concerned to execution-only rates for the remainder of the commission period."²⁰ Alternatively, it could be appropriate to increase the budget, although this would require careful controls and documentations to ensure that it is in the best interests of the client to do so.

By way of an example, the trading volumes of a manager across its research providers may be such that, with a contribution to research of 10bp, it had used up its budgeted amount 10 weeks into a three-month period. All trades would subsequently be carried out at an execution-only rate of, say, 7bp (giving rise to a conflict which is discussed later).

¹⁹ Some investment managers use CSAs with no pre-set allocation methodology.

²⁰ FSA (2012) 'Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks', p.7.

Since the 'Dear CEO' letter, there has been a growing trend amongst investment managers to set monetary budgets for research services independently from execution services. Specific recommendations to assist investment managers in developing frameworks to set and operate budgets are included in Appendix 1 of this report.

Benefits of current system

Most investment managers report a number of benefits that the current regime brings to their clients. These can be broadly categorised under three headings: incentives, efficiency, and research provision.

Incentives

- **Alignment with clients.** The interests of managers are aligned with clients because higher commission costs affect performance. If two otherwise identical funds bear different research (and transaction) costs, then the one with the lower costs will provide a better return for an investor.
- **Motivation at research providers.** Investment managers would argue that the lack of pre-negotiated payment amounts (as distinct from a nominal rate) keeps research providers incentivised to deliver research that adds value for clients.

Efficiency

- **Flexibility.** Research services can be used and evaluated by investment professionals and then paid for at a later stage, once it becomes clearer whether any value has been derived. Research only needs to be paid for if useful, thereby containing the cost. This flexibility is generally seen as beneficial to clients and is of special benefit to holders of those funds that have a global remit, where research consumption may change in line with investment focus.

- **Economies of scale.** The provision of research to a broad community of users creates significant scale efficiencies for research providers and consumers alike. These would be difficult or impossible to replicate at each investment manager individually, given there are over 40,000 stocks globally.²¹
- **Focus of internal expertise.** Investment managers spend substantial amounts on in-house research funded by their own resources. The existence of external research on some companies frees them to focus internal resource on the research activities that they believe will deliver the greatest benefit to their own clients.
- **Broker lists.** In practice, the adoption of CSAs has contributed to investment managers being able to reduce the number of executing brokers which they use, since they can now reward research from other research providers without trading with them, while in principle negotiating a better execution rate with each that they do use, reflecting the higher volume executed with them. While there was a trend in that direction as a result of costs, counterparty risk and general operational issues, the use of CSAs has accelerated this, which we believe is helpful in serving customer interests.
- **Competition.** As a result of their scale, larger client base and diversified range of investments, it is argued by some that larger firms are bigger buyers of research. Their payments to research providers therefore arguably contribute significantly to the availability and pricing of research services offered by brokerage and research houses alike. This is believed to help secure the availability of research per investor across the industry as a whole. This, in the light of the UK industry's long 'tail' of medium to small-sized investment firms, contributes to greater competition between those firms. (It should be noted in passing, that written research commonly must be disseminated to all at the same time to meet regulatory requirements concerning the release of material non-public information.)

²¹ Source: The World Federation of Exchanges.

Research provision

- **Scope of procurement.** UK-based investment managers can (in principle, and absent recent initiatives regarding corporate access in the UK) procure research on a global basis. This benefits clients through the provision of a considerably wider range of competitive research offerings.
- **Coverage.** Broking houses can provide greater coverage of stocks, which keeps the market generally well informed and benefits in particular those end-clients who are invested in less frequently covered areas, such as mid- to small-cap stocks, or emerging and frontier markets.
- **Distribution.** Research from full-service brokers is widely distributed, creating a network effect. Along with research from independent research providers, it plays an important role in establishing market expectations (consensus), thereby lowering volatility and contributing to more accurate equity valuations.

As will be discussed later in the report, perhaps the greatest impediment to the utility of the current regime is that a significant proportion of research is provided on what could be called an ‘unpriced’ basis by full-service brokers. This creates challenges which need to be managed. There are widely differing opinions from the investment management industry as to the significance of this problem, when balanced with the benefits.

In addition to the need for management of conflicts between clients and problems with the pricing/valuation model, there are other challenges:

- Governance of the procurement process (including, where relevant, management of the CSAs); and,
- Provision of meaningful disclosure to clients.

These will be further elaborated on in Section 2, with comments or recommendations in each of these areas covered in Appendix 1.

Section 2: Challenges

Research

The term ‘research,’ as applied to services provided to investment managers by third parties, does not reflect a single category but rather encompasses several different activities. At a minimum, it covers the provision of written analysis made available to all, bespoke work and access to analysts for advice and assistance. The absence of an exhaustive delineation of the range of services that constitute research thus adds to the challenge of ensuring the exclusive purchase of those research services that serve the interests of the clients that pay for them.

There is a need, made stronger by the changes proposed by the FCA in CP13/17, for a much clearer articulation as to what is and is not substantive research. This should extend to ascertaining sub-categories of research, which might then allow for improved oversight, better disclosure and greater opportunity for improved pricing. Whilst there is a risk in creating sub-definitions which are capable of wide interpretation (since providers may see scope to interpret in ways that align with their model), it is clear that a more detailed exposition of the term ‘substantive research’ would aid investment managers and so their customers. The IMA will continue to work in this area.

However, even leaving aside the risks arising from the absence of agreement as to what research encompasses, a significant challenge related to the current use of dealing commission is its method of generation.

Commission generation

Method of generation

While a small number of firms fund their research spend out of their own resources, the majority of firms pay for research services largely through dealing commission.

Under such an arrangement, the aggregate amount of research commission generated reflects the value of equity trades in any period, and the extent to which trading has been performed at execution-only rates, unless there are mechanisms in place to control this. This is because most of the money is set aside by attaching it to a trade with an agreed split between execution and research (see Section 1). Therefore in years when there is a higher level of trading, more research commission would be generated.

For example, if next year trading volumes for active strategies²² went up by 50 per cent, so would – all other things being equal – the amount spent on research commission. Of course, different arrangements across firms blending in-house and third party research consumption may yield different results. Additionally, some firms will set budgets that cap or alter this relationship, or just decide to pay less. But the fundamental point is that research spend historically tracks trading expenditure.

Most independent commentators might expect trading volumes, and therefore execution costs, to vary from year to year and to be heavily influenced by market conditions. It is harder to see intuitively why research spending should be similarly volatile and affected.

The challenge arises out of the fact that payment for research is tied to the payment for trading execution but is not directly derived from that purchase, and unless controlled by proper governance, it risks both distorting the basis for the valuation of the payment and weakening its verifiability. This is embedded in the so-called ‘linked-price model’, which characterises the way in which the current system pays for research through the use of dealing commission.

Linked-price model

Under this model, the pricing of execution services is correlated with the pricing of research services. In the absence of any form of price transparency in terms of

²² Trading for passive strategies should not be expected to contain a research component.

the research services provided by counterparties, it is one-sided to have the investment manager create a notional value of the service and attribute this via a bundled rate.

The model embeds conflicts in two ways:

- 1 The commission payment is made against the settlement instructions for a trade, irrespective of whether that trade has been made on the basis of the research service purchased; and,
- 2 The amount paid as research commission is calculated as a percentage of the bundled rate²³ irrespective of the fact that, at a fundamental level, it is hard to see on what basis these two services should be correlated in price.

As a result, the flaw of the linked-price model is its conflation of the mechanism by which payment is made with the methodology by which the price is determined. Added to this is another challenge, which relates to the way research is evaluated through the research vote.

Research vote

The valuation of research with the objective of rewarding value-added is certainly logical, and consistent with a competitive market. But the current research market displays some unusual characteristics in this respect:

- The supplier of research does not price it;
- The investment manager (the consumer of research) uses it before paying for it;
- The investment manager determines the quantum of reward paid to the supplier; and,
- The investment manager determines how much clients pay through agreeing the bundled rate and deciding what is traded on this basis or whether, alternatively, to use its own money.

While the characteristics may be unusual, the latter three points do bestow upon investment managers a certain degree of control over the process.

Alongside the benefits outlined in Section 1, the determining characteristic of the system – the absence of *ex ante* pricing inherent in any so-called ‘blind auction’ process²⁵ – introduces significant challenges in terms of transparency and oversight.

Acquiring research

Full-service suppliers provide research without reference to a specific price and against no contractual obligation to pay;²⁶ instead relying on an *ex post* price determination process. This commonly involves a negotiation of the agreed price by means of a comparison of the investment manager’s research consumption (in the form of meetings, analyst time, written research, etc.) and the amount of commission received. However, investment managers do not have information about each other’s bids, and there is no single winner or a published winning price.

Although pricing *ex post* often forms a basis for evaluating the following period, the absence of *ex ante* pricing or indeed a ‘winning bid’ creates the potential for distortive influences. It may shift the supplier-consumer information advantage to the side of the suppliers, leaving the price by which a manager is prepared to reward a broker vulnerable to distortions, notwithstanding the control that could otherwise come from the latter two bullet points above. This needs to be managed by good governance.

As mentioned to the IMA, a number of firms are also concerned that it creates the potential for full-service suppliers to discriminate against investment managers in areas unrelated to the provision of research, based on the level of commission spend.

It therefore has to be asked why the acquisition of research under this model has persisted in spite of the risks it introduces, with the response largely focused on the difficulties in valuing research.

²³ This presupposes a percentage pay-out model; there are investment managers which address this conflict by allocating monetary amounts to research payments.

²⁴ The term ‘blind auction’ refers to the fact that no fund manager (let alone any client of theirs) sees the price paid by others for research.

²⁵ Indeed, in this context the full-service suppliers describe themselves as ‘price-takers’ rather than ‘price-setters’.

Research valuation

The most frequently cited argument for the research providers' inability to price their services *ex ante* is their inability to determine their value to the research consumers (investment managers). The IMA and its members firmly reject this, albeit recognising that there are difficulties in the pricing of research services. Also some IMA members may wish to continue to be price-setters rather than price-takers, as they believe that this provides greater benefits to clients.

Price discovery and pricing method

Firstly, it is unclear why some system of price discovery cannot apply to the provision of research services. It applies to the provision of any other service in a competitive market, including that which – similar to research – involves a large suite of products and deals purely with intellectual capital. Moreover, price discovery incentivises the broker to deliver the best service for the investment manager; a relationship that is more difficult to sustain under a linked-price model.

Given the absence of price discovery in the market for research, one can ask if the chosen pricing method ought to rely so heavily upon the perceived value-added to each individual firm, rather than a more readily measurable and verifiable valuation method.

This is not a criticism of value-based pricing *per se*, which is commonly used in other industries. It is a challenge to its application to the market for research, given the basis on which value-based pricing methods might commonly be predicated:

- **Clients' prior informed consent.** The current model does not provide clients, as the ultimate payers for the service, with a choice as to whether they agree with the suggested level of the performance reward.²⁵ Disclosure, which would typically fulfil that function, is only focused on the quantum of spend.
- **Comparability of offering.** Under the current arrangement, the general lack of knowledge about

the levels of research payment does seriously undermine the ability of all parties to make overall comparisons of the service provisions available. At the same time, it must be acknowledged that the ability of an investment manager to negotiate the terms of research provision is a commercial matter and potentially sensitive.

The latter point, in particular, is the result of a general lack of market data which in other areas (eg. execution) enables scrutiny and intense price competition; in stark contrast to the opacity of the market for research. The provision of research from independent research providers offers some of the few external benchmarks for research spend.

Absence of market data

The current linked-price model which is employed by many firms and the absence of market data on the level of payment for bundled services undermines, according to many managers, efficient interaction on pricing between the three main sources of research in the market:

- 1 Full-service providers rewarded on a blind auction basis with little post-trade transparency;
- 2 Independent research providers, of which some have chosen to submit to the research vote process while many price on a subscription or project specific basis; and,
- 3 The input costs of investment managers' internal analysts.

There may be a need for a much greater level of available data about research costs. A well-functioning market should permit informed decisions to be made about the relative value for money of each type of provider and of the investment manager's own research capability.

Moreover, the existence of published data would ensure that investment managers were able to see not only the price difference on an offering by offering basis, but also the existence of outliers on

²⁵ Nevertheless high costs would impact the investment performance about which clients may make decisions, even if not directly consenting to the research spend.

the supply-side as well as the demand side. This is valuable information for the purpose of benchmarking third parties and an investment manager's internal arrangements, yet it remains inaccessible under the current system.

Inefficient demand and supply

One risk of the current regime is the over-consumption of research services or – to use a restaurant meal analogy – ‘over-ordering’. Individual managers could behave as if there was no practical limit to the research they could receive from suppliers. Linked with this is a concern that there is an over-supply of research of low or no value. Whilst the marginal cost of distributing written research is low and brokers are obliged to make some research available to the market as a whole (due to price sensitivity concerns), over-ordering and over-supply can impact market efficiency. However, overconsumption of research affects performance and therefore firms do have an incentive not to over-trade.

Availability of CSAs

It is important that any investment manager who wishes to use CSAs is able to do so. The IMA has no evidence of barriers in this respect, but in any review of the market, there should be a consideration of the position of smaller investment managers in agreeing and operating CSA arrangements; it has been reported that brokers may not allow smaller accounts to use CSAs. The IMA may also consider to what extent a model framework agreement might assist all parties.

Transparency

Clients may find it hard to understand what their money is being spent on. Current transparency

requirements are likely to provide a partial answer at best, as even a clear statement as to how much was spent by a manager on research is unlikely to give much information as to what types of research service that encompassed or any assessment of the manager's *ex post facto* assessment of the value added by the purchase.

With respect to any clients, managers are required to make adequate prior and periodic disclosure, which includes details of the goods or services that relate to the execution of trades and, wherever appropriate, separately identify the details of the goods or services that are attributable to the provision of research. Where the client is a UCITS fund, disclosure is made to the depositary/trustee. To date, there has been no public disclosure requirement and, to rectify this, the IMA is hereby committed to work that will deliver precisely such transparency, via its Disclosure Codes.²⁷ The costs paid from dealing commissions can be invisible to end-investors, ie. the people who own units in a fund. Although this is not the consequence of any malign intent, it is unsatisfactory that a small part of information on the investment managers' input costs has not been visible to the end-investor.

The IMA is, in other words, proposing that conflicts be mitigated through greater disclosure.

In conducting a review into its Disclosure Codes, the IMA will consult key stakeholders, such as the National Association of Pension Funds and the Association of British Insurers. The review will address both what is disclosed and to whom the disclosure is made available. Naturally, given the recognition the Codes have in the FCA rules, the IMA will need to satisfy the FCA that any revision is in the interests of investors.

²⁷ These IMA currently maintains two such Codes, allowing asset managers to report, in the one case to collective investment schemes; and in the second, to pension funds. The Codes are recognised in FCA rules.

Section 3: Looking to the future

This section introduces a debate about more fundamental changes to the existing regime as well as identifying a number of potential impediments. It proposes a standardised way of assessing the merits of any regime, existing or potential, in the form of Eight Measures.

The principal challenges in the current model identified by this paper are as follows (in no particular order of priority):

- a) Conflicts of interest embedded into the model;
- b) Lack of price transparency;
- c) Lack of ability for clients to assess the value of third party research for which they have directly paid;
- d) Risk of cross-subsidy benefitting one cohort of clients to the detriment of others;
- e) A risk of over-production of low and no-value research; and,
- f) Time and effort required on the part of investment managers to manage the model so as to ensure fairness, value for money and transparency for all clients.

Nevertheless the paper also identifies a number of benefits that participants believe accrue to clients generally as a result of the model. The benefits include:

- a) Client alignment due to any costs feeding through to returns, which ultimately have an impact on the size of funds (on which managers base their own charge as well as competitive advantage);
- b) Motivation of third party providers because their remuneration is determined *ex post-facto*;
- c) Flexibility;
- d) Economies of scale;

- e) Ability to focus internal expertise on highest-value work;
- f) Availability of research to start-up and smaller investment managers, promoting competition;
- g) Availability of research on SMEs and AIM-traded companies
- h) Ability to procure research on a global basis under a single model;
- i) Significant optionality, as investment managers are not tied contractually into any research services;
- j) Broad coverage of stocks; and,
- k) Company coverage by multiple providers leading to better consensus views, more accurate valuations and lower volatility.

Alternatives to the current model

An alternative to the current model would be for there to be a regulatory ban on the use of payment of dealing commission to purchase anything other than execution services.

This would create a cash model for research with managers or clients paying directly for services, whether on an item-by-item or a subscription basis. Investment managers would then determine what research and advisory services they wanted to procure without having to consider whether they met a regulatory definition of allowable services.

Under such a regime, services could be paid for in an open, transparent market where economic value would be more easily identifiable. Payment would be made to reflect the value received by the payer. (Some assert strongly that this is already the case where a well-governed process is in place.) Multiple models might develop (eg. subscription services and per-item purchasing) but the hypothesis would be that services that add economic value would prosper,

whilst those that cannot demonstrate value would disappear (although that does not necessarily mean that aggregate spend would decrease).

Whether these theoretical benefits would accrue, and whether they would be counterbalanced by damage in other areas, needs to be assessed in a thoughtful, thorough and measured way. This includes consideration of whether potential negative consequences have substance and whether they can be avoided or mitigated.

Framework for comparison

The eight measures (See Box 1, right) are intended for use in a comparison of different options. They provide a framework against which impact assessments, cost-benefit analyses and other judgements can be made to assess the comparative benefits of retaining the current regime in the UK, amending it in part, or moving to a regime in which dealing commission could not be used to purchase research.

The existing regime displays characteristics under each measure, some strongly, others less so. Each measure describes a particular feature. Under the existing regime, an assessment of how strongly some of those features are in practice present depends greatly upon the approach of any particular investment manager.

Alternative regimes can be distinguished and assessed by the applicability of any particular measure, as well as the extent to which its presence depends upon the efforts of particular actors or is an intrinsic characteristic of the proposed regime.

Impact of change

The proposition that investment managers should no longer be able to buy third party research through the use of dealing commissions attracts a wide range of views. It has its supporters as well as its detractors, but even support is often qualified by concerns around the impact on four broad areas:

- 1 International competitiveness;
- 2 Research provision, especially on SMEs and AIM stocks;

The Eight Measures of a Good Regime for Research Payments

Clients

- 1 The regime should operate in the best interests of the clients of investment managers. This is particularly important because those clients depend upon investment outcomes for their prosperity and security. They are also the key suppliers of capital to industry.
- 2 Investment managers, as agents of the clients for whose ultimate benefit the research services are procured, should behave demonstrably as the guardians of their clients' best interests within that regime, including conflict management and the provision of value for money.
- 3 Any cost borne by a client should reflect an investment manager's honest, fair and professional assessment that it is in the interest of that client to bear that cost.
- 4 Investment managers should disclose to their clients in a timely and meaningful fashion any costs or fees relating to the consumption of research borne by them or their investments.

Market

- 5 The research market should operate efficiently and transparently, so that investment managers can negotiate the best value for the research consumed for the benefit of their clients.
- 6 The market structure should ensure that a wide range of investment managers have access to a broad spectrum of competing research providers and service offerings and does not raise barriers to entry.
- 7 Research providers should not discriminate in their supply according to the use of other services, including execution and allocation.
- 8 The UK's regime for paying for research should not undermine the UK's international competitiveness as a leading jurisdiction for asset management and other activities associated with financial services.

- 3 Barriers to entry for start-ups and small firms; and,
- 4 UK plc.

International competitiveness

Concerns about the international impact are largely dependent upon the nature of an investment manager's business internationally. Many firms are concerned that a UK-only or even an EU-only legislative prohibition on the use of dealing commissions to purchase research could undermine the international competitiveness of the UK industry and increase operational complexity, thus driving costs that diminish client returns.

The concerns here arise from the global nature of trading. At an international investment manager, for example, orders made from the UK on behalf of UK clients to buy US shares can be aggregated with orders made on behalf of US clients by a US affiliate of the UK manager. This would aim to achieve economies of scale and to treat orders from different clients equitably. If, however, the US affiliate then directed an order to a US broker which executed the order on a bundled basis, then the UK manager would have to ask whether the UK client had consequently borne a research cost which led to the UK manager receiving a prohibited research service.²⁸

Alternatively, if the investment manager did not receive the prohibited service, but still paid the US bundled rate, then the UK client could be paying as much dealing commission as the US client for the execution but receive less for it, because the only service they would receive would be execution. As a remedy for that, orders for UK clients could presumably be traded internationally on an execution-only basis (to secure the lower rate). However, the potential impact on how UK client orders are traded, as compared with other international orders, could reduce the attraction of the UK as a centre from which many international investment managers organise their equity trading.

Consequently, the IMA is strongly of the view that any proposals to introduce change to the market such that research could no longer be paid for from dealing

commission need to be effected on a global basis. Rather than seeking to introduce regional change, say through MiFID, the International Organization of Securities Commissions (IOSCO) would appear to be the natural co-ordinating body.

Research provision

One of the concerns voiced to the IMA is that a ban on the use of dealing commission would cause a diminution of research provision. Although some commentators question whether, in many areas, there is not too much research with little or no economic value, this can miss the point. There may be many providers of research on blue chip companies; investment banks provide such coverage as part of their promotion of their capacity in the corporate finance world.

The real concern is that the provision of research for small and mid-cap businesses, the enterprises on markets such as the London Stock Exchange AIM, might be impacted. Particularly in the current economic environment, a consideration of Measures 6 and 8 demands particular attention as to whether proposed changes would help or hinder SMEs.

Barriers to entry

Some commentators have raised concerns that abolition of the ability to purchase research with dealing commission would advantage large asset managers, raise the barriers to entry for start-ups and threaten the sustainability of smaller asset managers. This might not serve clients well in the long run, as barriers to entry and the scale needed to compete could prevent new entrants, dampening innovation and reducing competition. Again, such impacts must be carefully assessed.

An additional aspect is that, as now, the impact of any regime change on managers with a single client fund (as is seen with some hedge funds) will likely be different compared to a small asset manager seeking to run several mandates.

²⁸ 'UK client' meaning here a client entitled to the protection given by the FCA COBS rules. Identifying on a global basis what business is covered by these rules is far from straightforward in some international relationships.

UK plc

Under the current model clients pay for externally-provided research through dealing commission. In theory, if this model were to be banned, investment managers could seek to agree with clients either directly to pass on the costs to the client or to incorporate those costs into a higher management charge without increasing total costs (as the research costs would simply arise in a different place).

However, in the current deflationary environment for asset managers' fees, in practice, many firms believe that this may not be possible and that the impact therefore would be significant.

Assessments of the impact of the banning of dealing commissions as a way of purchasing research will need to consider the extent to which investment managers would be able to adapt their business models such that theoretical improvements in efficiency in the research market are not lost as a consequence of the reduced sustainability of many firms, leading to reduced tax revenues.

In addition, more money is spent on research produced in the UK than is paid by UK clients. If the impact of a change in regime was to reduce aggregate activity, this would be a negative impact on what are essentially UK exports that support UK jobs.

There may be impacts on the sell-side but in this case, an assessment would have to be made about the risk that full-service brokers would be able to alter other parts of the value chain to extract the same overall return. For example, if aggregate research spend fell, would there be an increase in spreads to compensate? The bond market offers a pointer – there is no commission in the bond market, research

is provided without a charge, but effectively, its cost is covered through the spread.

The existence and extent of cross-subsidisation between research and other parts of a broker's business is not visible. But the eight measures proposed in this section incorporate an expectation that the impact on dealing spreads and other services from brokers will be evaluated before any significant change.

A number of firms are concerned that some investment managers may already be favoured or prejudiced in the allocations of IPOs, according to their payments of dealing commission. They fear that this will become accentuated if changes of dealing commission rules are limited to the UK. The work behind this report notes concerns amongst some that changes to the use of dealing commission would exacerbate their lack of confidence in how such allocations are determined.

Both the Kay Review and the IMA's long-term commitment to promoting good stewardship support the value of long-term engagement; this means that the UK industry is at the forefront of such approaches. Whilst some wish for more to be done, changes to the FCA's public stance about payment for corporate access have unsettled the market and how outsiders perceive (even if erroneously) what engagement is permitted in the UK. This serves as a reminder that the other impacts mentioned above, if realised, could cause damage to the standing of the UK as a listing venue and global centre for financial services.

A further consequence of requiring direct payment for research is that it could move from a VAT-free to a VAT-able environment, with potentially significant cost impacts on consumers.

Conclusion

A ban on the use of dealing commission does not, in and of itself, improve valuation in the market. This is why change requires (end-client-focused) co-operation from the providers of research, primarily the global investment banks.

As stated in Section 2 (second paragraph), the IMA considers it is important that the industry as a whole now seeks to come to a better understanding of the different types of goods and services that can amount to research. Linked to this would be the possibility that budget processes at investment managers could assess value in each of these distinctive areas on a different basis.

It appears the market may now be on the cusp of radically improving how investment managers operate the use of dealing commission regime. To do this, and to maintain the advantages of a global procurement model and many of the other advantages of the current regime, investment managers will need to be clear in their requirements for additional information or changed services and models from the research providers. IMA invites investment banks to demonstrate greater transparency to the market. Against a much clearer categorisation of different research and advisory services, this could give rise to significant changes and improvements in securing value for money widely across the market.

Appendix 1 of this report makes a series of recommendations to address how investment

managers can improve best practice under the current regime. It is critical that research providers work with investment managers to improve the information exchanges that some of those recommendations require. This is important for many, as the market is seen as structurally imposing limits on efficiency which no individual investment manager can overcome and which no individual research provider may feel obliged to alter.

Even in 2003, in CP176 (at its paragraph 4.28) it was hoped that a market could develop in ways that meant that new bases for reward could be used. If this does not happen, then when setting budgets, despite their best efforts and the approaches which have been outlined in this report, managers may still have to over-rely on an approach (however sincere and forceful) which requires them to negotiate in a blind auction process. A likely response from many could be just to pay less than in the previous year on a like-for-like basis. It is unclear whether this approach would serve smaller businesses, let alone whether clients would be advantaged compared to a market that had greater price transparency.

At the same time, whilst it is to be expected that significant changes will occur in budgeting, governance, transparency and disclosure, the industry should also be willing to explore whether different methods of supply and payment would in fact serve clients better than the current regime, if implemented on a global basis.

“These recommendations will contribute materially to a system for research payment that clearly and demonstrably support and enhance the alignment of investment manager and client interests.”

Accordingly, the IMA stands ready to play a full, open-minded and positive role in any regulatory review and will aim to ensure that any assessment of alternative models includes a careful consideration of the costs, benefits and impacts, using the eight measures. In the meantime, the IMA sets out in the first appendix to this paper, recommendations to support and promote the changes already occurring at many investment managers.

The IMA believes these recommendations will contribute materially to a system for research payment that clearly and demonstrably support and enhance the alignment of investment manager and client interests on a consistent basis, over time and across firms, by focusing on the evaluation of research and budgeting for its use.

Appendix 1: IMA Recommendations to improve current practice

This Appendix presents a series of proposals that investment managers should consider (if they have not done so already) regarding the duties they owe to clients in relation to research procurement. The recommendations build on work (described below) with members and have been made public to assist in a wider debate about the current regime for purchasing research via dealing commission.

It is uncontroversial that – in procuring, consuming or evaluating research services – investment managers should be just as diligent when using dealing commission as when they fund the purchase themselves. It follows that a system that prominently reinforces this principle will be the most effective in promoting that standard widely and consistently. There is a subtle but potentially important difference in approach towards a service, depending on whether or not it appears to be free at the point of consumption.

In December 2012, the IMA set up three working groups to consider aspects of the FSA's 'Dear CEO' letter. Reflecting the three sections of the letter, the groups looked at firm policies, trading policies and business culture.

Output from the first and third of these working groups provided useful pointers for firms considering their own review of conflicts. They were made available to IMA members in January 2013.

In March 2013, the IMA released a paper designed to assist 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. That paper was made public subsequent to consultation with interested parties.

Necessarily, some proposals are more or less applicable to particular models but the IMA is not recommending any particular model (whether direct payment or use of dealing commission, or whether

the latter should entail CSA usage or bundled trading). Given that the FCA rules do not prescribe a single approach, the IMA's proposals are intended to help its members consider, and enhance, their compliance with the rules on use of dealing commission and conflicts of interest. They should be read proportionately having regard to the nature and size of an investment manager and its business. Greater clarity and control is always to be preferred over increased bureaucracy or box-ticking.

The proposals also need to be read proportionately in light of the points made in this report, particularly as regards the challenges concerning pricing in a market with a significant amount of unpriced, bundled supply. Accordingly, there are real limits to what investment managers can achieve in relation to some of the issues which follow.

The proposals cover:

- a) Budget-setting;
- b) Commission generation;
- c) Research vote process; and,
- d) Conflicts with clients.

Budget-setting

The 'Dear CEO' letter stated that too few of the firms visited adequately controlled spending on research and execution services. A measure of that was whether the investment manager "exercised the same standards of control over these payments that they exercised over payments made from the firms' own resources."²⁹

One example of good practice mentioned was where a firm set a maximum spend on research services for any one period and, once these limits were reached,

²⁹ FSA (2012) 'Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks', p.7.

switched commission rates for the brokers concerned to execution-only rates for the remainder of the commission period.

This reflects a central tenet of the current FCA rules that, to the extent possible, decisions over the provider of execution should be separated from the choice as to which research provider is rewarded. The benefit of such a separation is not only to ensure the best suppliers are used for each service but also that the costs of each service can be controlled independently.

The FCA's identification of good practice begs the question of how an investment manager determines at what point to switch (to execution-only), in order to ensure that clients obtain the best value for money from their payments towards research. One obvious risk stemming from the current model is over-consumption (and over-payment connected with over-ordering) of research services, not helped by the relative paucity of restrictions or even feedback mechanisms on the levels of research consumption.

It is a given that trades for which there is no need to purchase research should not in principle be traded at a bundled rate as mentioned in Section 1, but once they have been excluded, as FCA mentions, controls must then be applied to those which carry a research cost. The IMA's view is that it is inappropriate for the aggregate value of research commission generated merely to reflect trading levels in any period, without being constrained by some consideration of the value of the research services charged to clients.

Investment managers should set research budgets.

Although budget-setting could be approached as a purely fiscal exercise, investment managers also need to carefully consider how they consume research services, taking into account a number of issues.

Investment managers should employ a process to set an amount of research credits that they expect to generate. That 'research budget' can vary on the basis of a number of factors and is, due to inherent shortcomings in the structure and transparency of the market, challenging to determine and control.

A budget would be applied to the investment manager's overall expenditure on dealing commission for research. Investment managers should consider the following five questions, on each of which we elaborate below:

- a) Whether to set a maximum (as the FCA mentions)
- b) At what level to set a budget
- c) Who should inform the budget
- d) What should inform the budget
- e) How to incorporate a mix of forward- and backward-looking considerations

Whether to set a maximum

The IMA considers that the 'Dear CEO' letter should not be read as a statement that only a maximum figure is acceptable. Rather, a budget set to reflect on a reasoned basis the investment manager's likely requirements for research services in the foreseeable future would seem more appropriate. A budget should have an indicative maximum, but in concept a budget ought to be capable of being revised up or down.

An investment manager should not be hindered from supporting an increase in future research, if it is legitimately concluded that this serves the best interests of its clients, eg. as a result of expanding its stock coverage into a new market or industry or because of exceptional market conditions.

At what level to set a budget

Although the FCA refers to the brokers "concerned", this should not require a budget to be set for each broker individually.

At some managers, the research budget consists of distinct 'purses': the first being dealing commission, the second being internally funded. This second component may amount to a significant proportion of the value the investment manager can commit in research spend through dealing commission.

But even where investment managers do not have their own budget for external research, they may have

significant internal resources in the form of analysts employed by them.

A key purpose of budget setting, however, is to impose a discipline specifically upon the use of dealing commission to purchase research. It is necessary therefore that any wider budget-setting process allows that component to be identified and monitored separately from the use of own resources.

Who should inform the budget

It is a key part of the use-of-dealing-commission rules that the role of trader and discretionary portfolio manager are separated. This is achieved by functional separation, which will naturally extend into the budget-setting process. Traders at buy-side firms, therefore, should not be determining the research budget; nor should individuals making the investment decisions direct where trades occur. Moreover, compliance departments have a key, perhaps central, role in ensuring that the services to be purchased constitute substantive research. (See Section 2 for details on defining this.)

What should inform the budget

For many – but not all – investment managers, the setting of a budget is part of the enhanced approaches that have been developing over the course of 2013.

At this time, the IMA believes it is important that these recommendations are not over-prescriptive as to what factors should inform any process for setting budgets. Nevertheless any budget is likely to be informed by qualitative factors and quantitative data inputs.

Quantitative inputs could include comparisons of a budget as a percentage of value of relevant assets under management; a percentage of total commissions generated; or some measure of value generated for clients. Indeed, the growing interest in, and use of, budgets will no doubt spawn other metrics. Which approach should be used is best left to market developments and not prescribed at this time. No doubt it will also reflect the nature of any investment manager's investment process and the materiality of any (measurable) benefit from implementing a system of measurement, compared to its cost.

How to incorporate a mix of forward- and backward-looking considerations

It is important to consider the parties likely to be paid from the budget. Some, commonly independent research providers, will provide services for a fixed price (including subscriptions), facilitating budget-setting. Others will be paid either through bundled execution or under a CSA.

An *ex ante* determination of expected consumption can, in combination with regular feedback, help managers to identify balanced research budgets.

Budgets should reflect the expected benefits to clients; in other words, the production of a budget can be thought of as part of treating customers fairly.

Robust methodologies will help to guard against any concerns (even if unjustified) that the individuals at investment managers might want to reward full-service brokers for the provision of other services, such as for execution and non-research services. Amongst these are the fears of intangible risks such as not being provided with IPO allocations from other parts of a full-service broker. (It is outside the scope of this paper but the market would benefit from greater clarity as to the responsibilities of all parties on this issue.)

Review and control

Appropriate budget periods should be agreed and reviewed at regular intervals

Although the FCA recommendations on research consumption refer to oversight, one area of budget-setting relates to the manner in which payment is made. The FCA refers to switching from a full-service rate to an execution-only rate, when a maximum spend is reached. This could introduce a new form of conflict of interest, between clients whose transactions are executed before the switch to execution-only and after. It might be argued that the impact of switching is such that, for specific clients, it will even out, as trading could be sufficiently spread across any period. Analysis of trade data could help establish or disprove this, but there may be better ways to achieve budget discipline.

Firstly, by considering how quickly any maximum is reached in a period, bundled rates could be altered for trades in future periods, so as to try to match better the end of the period with when the cap is reached. Another response, seen at some investment managers, is to blend the trades between bundled rates and execution only, so as to reach the maximum more smoothly and avoid cliff edge effects with a sudden switch. Adopting smaller budgetary periods can help mitigate the effects of uneven trading across clients. This does not entirely obviate some clients having a different treatment to others but it may randomise the distribution of impacts. The blended approach may, of course, demand technology spend.

Any budget-setting cannot be made in isolation from an investment manager's experience of how research votes allocate value to specific research providers. A budget will impose limits on what previously would have been paid out using the percentage payment model (whereby the research vote determines percentage allocations from a whole pool for research payments). A budget may, of course, also impact situations where the research vote has previously determined an absolute monetary amount.

Whenever any combination of budget and research vote means there is a residual balance of dealing commission left at a broker at the end of any period, investment managers will wish to consider whether they can recapture any balance for the benefit of clients or whether it is better to leave it for use in a future period.

Disclosure

Clients may expect to be provided with a description of the factors which have been considered at any investment manager in aligning their budget methodologies with those clients' best interests. As mentioned earlier (see Executive Summary), the IMA will now review the Disclosure Codes which it promulgates.

Paucity of data points

There are relatively few external data points which can be used by investment managers to determine an appropriate budget. This reflects the challenges

which arise from the blind auction process, which dominates price setting in this market.

There are market initiatives to provide benchmarking. In the meantime, however, in comparison with the vast amount of data available to allow investment managers to analyse and compare the cost of execution services across a variety of providers and execution venues, the absence of data about research costs is particularly stark.

The IMA will work with its members to identify any potential wider industry initiatives in this area that would be beneficial.

Commission generation

Given the amount of research-oriented dealing commissions which may be generated in any period, investment managers need to ensure measures are in place in order to direct and account for them appropriately and without unnecessary delay.

Oversight

The IMA recommends investment management firms have clear reporting lines and oversight, with escalation processes and management information, in relation to both the generation and allocation of research spend. To the extent they have not already done so, investment managers should consider whether to form a research oversight committee.

Any research oversight committee that does operate can helpfully be informed, but not chaired by, individual portfolio managers. A member of the compliance department should have clear responsibility to consider the commission generation and expenditure process.

It is important that investment management firms properly oversee the process of research-commission generation, even if they outsource that process to external administrators or research providers.

Investment managers will consider what management information is needed, both for any oversight committee and more widely. The IMA is open to

consider with its members whether to provide examples of appropriate oversight models.

Reconciliation

Reconciliation is essential, particularly where CSAs are used

As part of the control function, it is essential to have reconciliation of a) the amounts actually held, for later allocation, with b) records of what should be held. Whether bundled at one provider or operated through one or more CSAs, the balances held need to be reconciled with the trades which generated them on a periodic basis. Investment managers will want to ensure that when payments are made, and these are commonly in batches from CSAs, there is a proper reconciliation with escalation, as might occur for bank balances held by the investment manager.

Of course, the amount and time of a trade is already checked through the need to match trades for settlement purposes.

Documentation

IMA recommends fully documenting any CSAs

Consideration should be given to provisions relating to:

- Who is authorised at the investment manager to direct payments;
- Reporting obligations and standards, including breach and error notifications;
- Dispute resolution clauses;
- Key embedded risks such as foreign exchange rates and responsibilities;
- Clarity as to the existence of credit risk (on which we expand below);
- The timeliness of payments; and,
- Clarity about unused balances.

As mentioned in Section 2, the IMA will consider whether it would be appropriate and beneficial to develop model CSA clauses or a model framework agreement.

Credit risk

Balances at research providers introduce a form of counterparty risk. Formulations such as stating that a broker holds money as client money need to be underpinned by robust legal analysis. CSA balances are not automatically client money and, in order for them to qualify for treatment as such, one requires careful analysis in the context of the FCA's client money rules (with accompanying regulatory guidance) before adoption of such an approach.

Good practice would naturally include checking the creditworthiness of the brokers concerned at appropriate intervals.

The IMA recognises the impact that applying the current FCA rules on client money would have, in terms of cost, administration and risk, and this is an area in which the IMA will carry out further work. The FCA may have the power to impose some form of statutory trust on CSA pools, albeit with a more tailored, simpler regime than for traditional client money. If the IMA's further work supports this, the IMA would then ask the FCA to examine the benefits, costs and proportionality of this.

Timely usage

Expenditure, reporting and escalation procedures at the investment manager can ensure that balances are not allowed to build up beyond approved parameters

An investment manager might determine that it is prudent to direct expenditure frequently. (This will, of course, go a long way towards mitigating the credit risk discussed above.) Procedures should address any residual balances, particularly when those balances are left in place to the next period. CSAs should address this possibility and also whose responsibility it is to identify unused balances.

Research vote process

As part of the good practice mentioned in the 'Dear CEO' letter, one firm gave careful consideration as to which services represented valuable inputs to its investment process and challenged brokers about why it should pay for other services.

Certain principles, which reflect the fiduciary nature of discretionary portfolio management, are relevant to the research-vote process. In addition to the duty of investment managers to justify the use of client money as rigorously as the use of their own, one can identify the following:

The method of determining how research providers are rewarded should be aligned with the interests of the investment manager's clients

Monetary budgets should be set at an appropriately granular level, depending upon the nature of the investment process and internal arrangements of the investment manager. For some, a firm-level approach will be adequate; for others, matching budgets and their usage to teams of individual portfolio managers will be more suitable. But there should also be independent review and internal consistency checks, commensurate with the size and nature of the investment manager and its business. The ultimate goal here, of course, remains accountability to customers.

Robust governance models include several 'lines of defence'

In areas of expenditure outside external research, governance would conventionally involve a prior-year budget process, intra-year controls, management information, financial officer oversight, and end-of-year audit. These are expected minima in order to demonstrate stewardship and accountability in the interest of a key stakeholder group – the shareholders.

It is not suggested that these controls be replicated in their entirety for dealing commission. The focus is rather on a control-side dominated oversight process for the entire commission budget, with escalation of management information. For example, control may lie with an independent oversight committee (just as

remuneration might be) but a Board might receive reports on research commission spend if similar-sized spend from their balance sheet would be flagged within other reports the Board receives.

Some managers, use a rolling average of expenditure to assist with this, as trading peaks and troughs unrelated to stock selection (for example, driven by large inflows from customers) can distort the numbers over the shorter term.

Embrace wholly qualitative evaluations appropriately

An individual portfolio manager's opinion as to what research was valuable will always be needed. This will also support evaluations as to how well ideas are tailored to any individual's needs. Appropriate internal challenge and internal consistency checks can guard against excessive reliance on opinion alone.

Ensure the commission distribution is tested against objective factors where practicable

Appropriate records, both in type and volume, should be kept (or accessed from brokers) to provide a sense check as to the reasonableness of the value an investment manager ascribes to the broker concerned. Brokers could be asked to supply records of: access to analysts; the commissioning and delivery of bespoke research; and key pieces of research which appeared to be used. Too small an amount of records will of course make it difficult to form a view but, equally, there is a danger of being swamped in data that cannot then be assimilated.

Services which were not used or did not add value to the investment process cannot (under FCA rules) be provided with any distribution of commission. To make this practicable, sampling could check that the services being provided do meet the definition of substantive research.

Provide feedback to research providers in a form and with a frequency which connects the payment made with the resource valued

Whilst investment managers may allocate votes to research providers and tell them how many votes they obtained, it is often far from clear to the broker

what more precisely is being rewarded or how the broker/research provider might alter or improve its service, ultimately to benefit the investment manager's clients. The frequency of providing such feedback to research providers should be measured so as to strike an appropriate balance, keeping research services relevant and additive without encouraging views and analysis that are short-termist.

Conflicts with clients

As part of further response to the November 2012 'Dear CEO' letter, this Appendix provides a checklist of conflicts of interest which may arise under various arrangements for paying for research with dealing commission. The checklist is provided to assist i) any internal review and ii) consideration of appropriate client disclosures. The IMA will do further work on this with its members, identifying best practice.

Potential conflicts

Are there different impacts on clients dependent upon their size?

It is likely that large clients will have larger trades than small clients. Under the current system, research contributions are correlated to values traded, so larger clients may in practice contribute more towards the research spend than smaller clients.

Are there impacts from switching to execution-only rates when a budget limit is reached?

If a firm trades bundled until the budget is hit and then it trades execution-only, there could be a conflict between clients who trade in the period before the budget target is reached and those who trade afterwards. Even if a firm uses a blended approach, there can be different treatments for different clients.

Does it matter if budget setting is forward- or backward-looking?

Leaving aside valuation issues, there is an open question as to the nature of conflicts (if any) that arise, if research spending is committed on a forward-looking basis, as compared to a backward-looking basis.

Are clients differentially affected by differing research appetites?

Conflicts arise where the clients whose trading generates the research credits are not the same identical clients as those for whose benefit the research is consumed.

An example is where different clients are looked after by different teams, so that one team in a firm may generate more trading but another team may gain greater consumption of, and benefit from, the research.

Also where different trading strategies generate different commissions this can lead to unequal cost sharing between clients.

Are clients impacted where trades occur on an international basis?

Is the research credit able to be spent by the geographic area where the trade was executed or by the area, if different, where the portfolio manager is located? Do firms reallocate overseas research credits to the UK manager?

Are clients impacted by the use of commission outside equity teams?

Research may be used by teams that are not involved in equity asset classes, most commonly fixed income; is this unproblematic, so long as the other team(s) who consume research have no impact on either i) whether research is purchased (by the equity team); or ii) the value at which it is purchased?

How should firms deal with international trades, which may come bundled with a service that is allowed in the country of execution but is ineligible as substantive research in the UK?

This is a profoundly difficult issue. Narrowly, it may depend upon the extent to which the FCA's rules apply; but translating that into a global business is testing many investment managers, especially as the FCA may take a purposive approach to its rules. The use-of-dealing-commission rules appear not to envisage a process to rebate any cost which could be attributed to the ineligible service.

Appendix 2: IMA actions

Mixed usage calculation

The IMA will consider the basis for attributing cost to permitted research, and how to ensure only that (permitted) portion is paid by the client. Likewise, it shall consider the question of whether there should be a measurement of the value received by the investment manager (see p.7).

Research taxonomy

The IMA will work with its members to develop a more detailed exposition of substantive research services (see p.12).

Model clauses and framework agreements for Commission Sharing Arrangements (CSAs)

The IMA will consider whether model CSA clauses and a model framework agreement might assist parties in agreeing and operating CSA arrangements (see p.15 'Availability of CSAs' and p.26 'Documentation').

Review of IMA Disclosure Codes

The IMA will conduct a review into its own Disclosure Codes, in consultation with key stakeholders such as the NAPF (National Association of Pension Funds). The review will consider both what is disclosed and to whom the disclosure is made available (see p.15 'Transparency').

Data provision on the cost of research

The IMA will consider with its members the appropriateness and benefits of encouraging wider industry initiatives in the provision of data about research costs (see p.25 'Paucity of data points').

Oversight of commission generation

The IMA is open to consider with its members whether providing examples of appropriate oversight models might aid investment managers in determining what management information is needed for oversight committees and more widely (see p.25).

Credit risk

The IMA will explore ways of mitigating credit risk in CSAs (see p.26).

The conflicts

The IMA will be working with its members to provide insight and to establish industry best practice in dealing with the conflicts listed in Appendix 1, including as regards trades bundled internationally, where one service may be allowed in the country of execution but may be ineligible in the UK (see p.28 'How should firms deal with international trades...').

