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UK Regulators Amend Dealing Commission Rules

On 8 May 2014, the U.K.'s Financial Conduct Authority (the FCA) issued Policy Statement 14/7 containing rules clarifying aspects of the goods and services that U.K. asset managers can buy with dealing commission. The Policy Statement is broadly in line with the FCA's Consultation Paper ([CP 13/17](#)) (please refer to our [briefing](#) of 2 December).

Background

In the U.K., "dealing commission"¹ is used by asset managers to obtain specific goods and services, permitted by the FCA's rules, such as investment research from brokers. These services are additional to the broker's trade execution services. The asset manager's clients typically bear the cost of the dealing commission paid to brokers.

Under existing FCA rules, all U.K. asset managers must have reasonable grounds to be satisfied that these additional goods and services:

- are related to order execution² or comprise the provision of research;
- will reasonably assist them in the provision of their services to the clients on whose behalf orders are being executed; and
- do not, and are unlikely to, impair their duty to act in clients' best interests.

The FCA's Consultation Paper identified failures by some U.K. firms to make appropriate judgements and apply adequate controls in relation to their use of dealing commission, especially in the area of research. The FCA considered that asset managers had "pushed the envelope" by using dealing commission to pay brokers to facilitate corporate access to issuers' directors and senior managers, without being able to justify how these payments satisfy the above criteria.

The FCA has now clarified the current rules so that the circumstances in which dealing commission can be paid is likely to be interpreted more narrowly. This includes an express ban on the use of dealing commission to pay for corporate access.

The New Rules

The final rules, which will come into force on 2 June 2014, are broadly the same as those proposed in the Consultation Paper with some modifications.

General Clarifications

The new rules will re-cast the existing exemption so that dealing commission can be paid if:

- A. the asset manager has "reasonable grounds to be satisfied" that the goods and services received reasonably will assist the asset manager in the provision of its services to its clients who are bearing the cost of the dealing commission;

¹ This process also is referred to as "softening," and the commission is referred to as "soft commission."

² The dealing commission rules cover trading in shares or other share-related financial instruments for the asset manager's clients – e.g., warrants, options, GDRs and ADRs.

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- B. the receipt of those goods and services does not, and is not likely to, impair compliance with the duty of the asset manager to act in the best interests of its clients; and
- C. the goods or services are either directly related to the execution of trades on behalf of the clients, or amount to the provision of substantive research.

The FCA originally had proposed that the “reasonable grounds to be satisfied” test be removed entirely from the exemption. However, industry feedback raised concerns that this would turn the regime into one of strict liability. It was argued that this was inappropriate because the question of what constitutes the provision of substantive research will involve the exercise of the asset manager’s reasonable judgement. The FCA retained the “reasonable grounds to be satisfied” test for point A above because substantive research may vary in its relevance to a manager’s day-to-day investment or trading decisions over a period of time.

However, the “reasonable grounds” test has been removed from points B and C above. The FCA takes the view that removal will not represent a significant change, because U.K. asset managers already should have sufficient systems, controls and records in place to demonstrate their compliance with FCA regulatory requirements. As a result, the FCA argues that there should be no resulting increased evidential or disclosure burden for asset managers, assuming their compliance with current rules.

‘Substantive’ Research

The new rules will require research to be “substantive.” This appears to be a clarification of the existing requirement that broker research must give asset managers “meaningful conclusions based on the analysis or manipulation of data”³ in order to ensure that asset managers’ clients are effectively paying for worthwhile output. The FCA confirmed in the Policy Statement that meaningful conclusions are not simply restricted to buy, sell or hold recommendations. A meaningful conclusion could include a summary or statement of opinion, or even a reasoned deduction or inference. Substantive research also can be presented verbally.

Corporate Access

The new rules will ban the use of dealing commission to pay for corporate access.⁴ Corporate access is defined as “a service of arranging or bringing about contact between an investment manager and an issuer or potential issuer”.

Unbundling

The new rules also address how asset managers should address “mixed-use assessments” where goods and services that cannot be purchased through dealing commission (such as corporate access or research that is not “substantive”) are bundled with “valid” goods and services. In such circumstances, an asset manager should “unbundle” the “invalid” elements so that its clients only bear the costs of those goods and services that can be validly paid for.⁵ New FCA guidance suggests that the asset manager may value the invalid elements by considering the amount that it would be willing, in good faith, to pay for them.⁶

³ COBS 11.6.5.E(1)(d).

⁴ See COBS 11.6.8 G(4A) and glossary definition.

⁵ COBS 11.6.8A.G(2)(a).

⁶ COBS 11.6.8A.G(2)(b).

Conclusions and Action Points

U.K. asset managers should review existing procedures to ensure that they will continue to be compliant. Managers also should ensure that their records will be sufficient to demonstrate compliance with the new requirements as dealing commission has become a hot regulatory topic in the UK. This is particularly important in the area of investment research, where the service may include verbal communication as well as written research reports.

Asset managers will need assistance from brokers and other counterparties to assign appropriate fees for corporate access and any research that does not meet substantive tests.

A focus on substantive research will result in asset managers becoming more selective in choosing investment bank research offerings. Press reports indicate a potential significant fall in income from equity research at investment banks, especially if the FCA's approach is adopted by regulators outside the U.K.

These changes represent the start of potential wider reforms to the use of dealing commission. The FCA intends to use the EU MIFID II implementation process to seek further EU-wide changes in this area. The FCA has repeated that it may unilaterally implement radical reform in the absence of EU agreement and may insist on unbundling substantive research from execution costs. However, further U.K. reform in this area is not expected before 2016/17 when MIFID II is due to be implemented and will not be undertaken without a significant consultation process.