

UK Regulators Begin the Shake-Up of Asset Managers' Use of Dealing Commission

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On 25 November 2013, the U.K.'s Financial Conduct Authority (the FCA) issued a consultation paper proposing new rules to clarify the circumstances in which U.K. asset managers can currently pay dealing commission (CP13/17). (Dealing commission is sometimes called soft commission.) The new rules, which are expected to be in place in Q2 2014, will apply to all FCA-regulated asset managers operating from a UK place of business. The consultation closes on 25 February 2014.

The consultation is part of a wider FCA initiative to reform the dealing commission regime launched in October 2013 by FCA CEO Martin Wheatley. This effort may lead to more radical changes.

Immediate Proposals

The current consultation proposes changes to the dealing commission regime that the FCA believes can be made relatively quickly.

Currently, U.K. asset managers can use dealing commission to pay for both sell-side brokerage fees and investment research. Dealing commission is normally a fund expense and is typically a bundled cost. The FCA believes that asset managers have "pushed the envelope" and stretched the definition of investment research to include payments to brokers to facilitate access to directors and senior managers of issuers (corporate access). The FCA has estimated that £500m of dealing commission was spent in 2012 to facilitate corporate access.

Therefore, the FCA proposes that only goods or services "directly related to the execution of trades on behalf of the investment manager's customers"; or which amount "to the provision of substantive research" can be paid for using dealing commission.

Asset managers also will need to explicitly consider their duties under the FCA's client's best interest rule when considering whether to pass charges onto their clients. Therefore, asset managers must:

- not pass on a charge that is greater than the cost charged by the person providing the goods or service; and
- act honestly, fairly and professionally in accordance with the client's best interests when they are in a position to negotiate (or dictate) the price of the goods or services to be charged to the client.

Asset managers will have to "unbundle" substantive from nonsubstantive research so as to ensure that only substantive research costs are passed on to the fund or managed account.

Asset managers will be banned from paying for corporate access with dealing commission. In the FCA's view, corporate access does not amount to investment research because it lacks original thought, critical analysis and evaluation of information or meaningful conclusions. Therefore, the FCA believes that corporate access costs should not be paid out of dealing commission, but can be borne by the asset manager.

Wider Initiative – Possible Future Developments

There are a number of bigger issues in this area that will only be resolved following a wider and longer consultation.

The first issue is whether dealing commission should be unbundled, so that execution costs are separated from investment research costs and disclosed separately to clients. The FCA appears to be suggesting that unbundling could result in asset managers having a greater incentive to reduce investment research costs by only paying for necessary research and seeking to negotiate cheaper pricing. A second, more radical, option would be to prevent asset managers passing on investment research costs to their clients.

If the FCA were to decide that radical reform was necessary, it is likely to first seek agreement from other EU regulators (through the MIFID 2 process) to implement reform across the whole of the EU asset management market. However, in the absence of such agreement, the FCA has indicated that it may decide to proceed alone in the U.K.. The FCA has referred to the U.K.'s RDR reforms, which banned the payment of commission to retail market intermediaries and has indicated that other regulators and the market have moved towards its approach.

However, it is not yet clear that the wider EU market would move towards unbundling dealing commission, if the FCA does decide to proceed alone. There is, therefore, some market concern that FCA action on unbundling without wider EU regulatory agreement could disadvantage the UK asset management industry.

Regardless of what happens over the next year or so it is clear that the spotlight is on asset managers' use of sell-side research. We expect that regulatory focus on dealing commission will force asset managers to look more closely at the quality and required scope of the sell-side research that they receive.