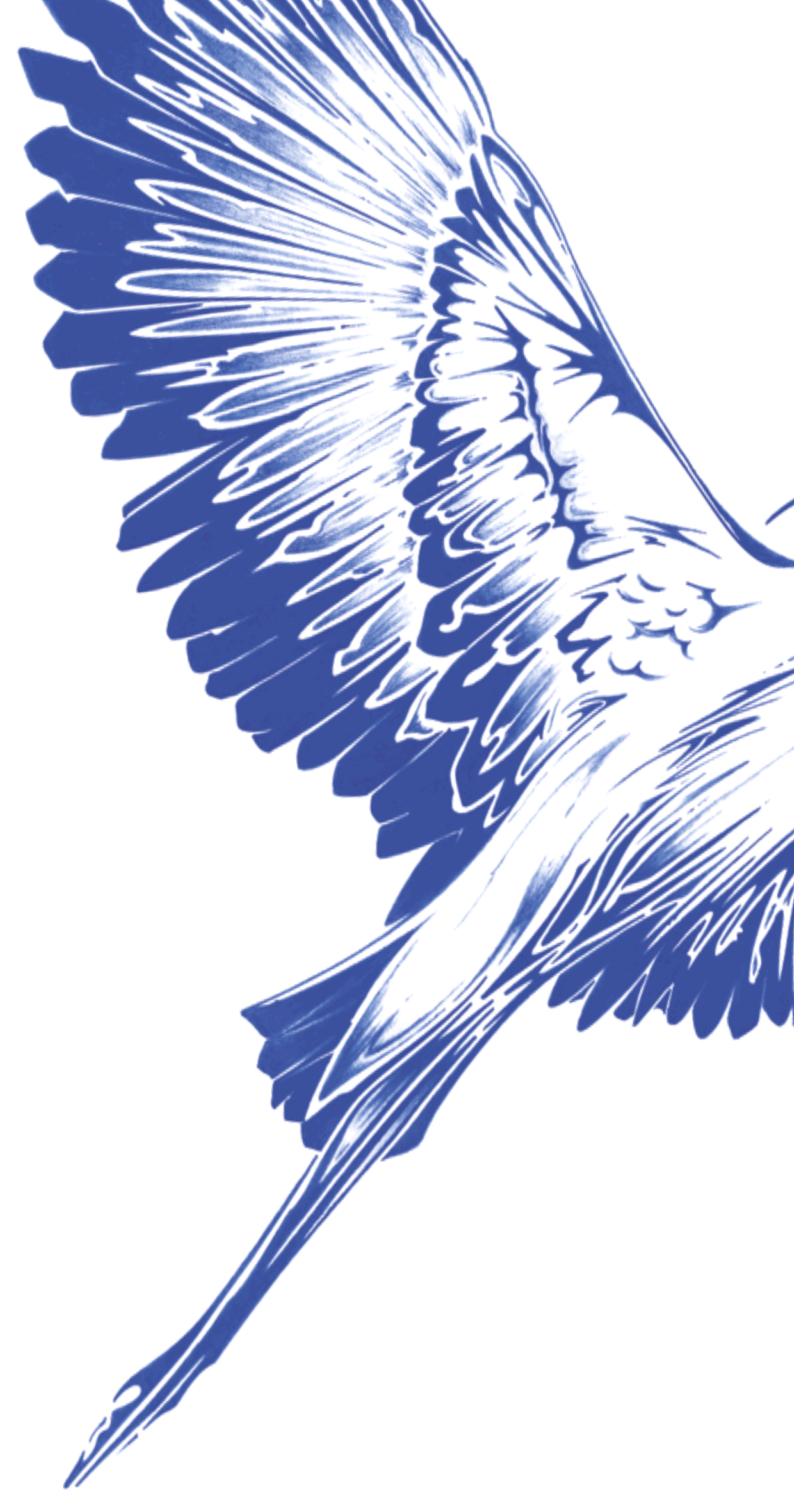


**CLEVELAND & CO**

External in-house counsel

# USE OF DEALING COMMISSION – CURRENT RULES, PRE-MIFID II

August 2014



## Key points

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### RULE

COBS 11.6.3(1)

**An investment manager must not accept any good or service in addition to the execution of its customer orders, if the good or service is offered in return for the execution charges and these charges are passed on to its customer.**

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### EXCEPTIONS

COBS 11.6.3(3)

1. The investment manager has reasonable grounds to be satisfied that the good or service received will reasonably assist the investment manager in the provision of services;
2. The investment manager's receipt of that good or service does not, and is not likely to, impair compliance with the duty to act in the best interest of its customers; and
3. The good or service is **directly related** to the execution of trades AND amounts to the provision of **substantive research**.

***“Directly related” means:***

- *It must be linked to the arranging and conclusion of a transaction; AND*
- *Provided between the making of the investment decision and the conclusion of the transaction.*

***“Substantive research” means:***

- *It must be capable of adding value to the investment decision;*

- *Represent original thought in the critical and careful consideration and assessment of new and existing facts;*
- *Have intellectual rigour, not merely stating what is commonplace; and*

*Present meaningful conclusions based on analysis or manipulation of data.*

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## PROHIBITIONS

COBS 11.6.6-11.6.11

- Post-trade analytics;
- Price feeds or historical price data not analysed to present meaningful conclusions;
- Services relating to valuation or performance measurement;
- Computer hardware;
- Connectivity services (i.e. electronic networks and dedicated telephone lines);
- Seminar fees;
- Corporate access services;
- Subscriptions for publications;
- Travel, accommodation or entertainment costs;
- Order and execution management systems;
- Office administrative computer software (i.e. word processing or accounting programmes);
- Membership fees to professional associations;
- Purchase or rental of standard office equipment or ancillary facilities;
- Employees' salaries;
- Direct money payments;
- Publicly available information;
- Custody services (excluding services incidental to execution);
- Any arrangement that could compromise best execution obligations.

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## PRICING GOODS AND SERVICES

COBS 11.6.8A

1. An investment manager should not pass on a charge that is greater than the cost charged;

2. If the relevant good or service is not distinctly priced, the investment manager should make a fair assessment of the fair charge that it would be permitted to pass onto its customer. Can the investment manager carry out a fact-based analysis of the unpriced good or service i.e. comparable priced good or service?
3. Where the investment manager is in a position to negotiate or dictate the price, the investment manager should act honestly, fairly and professionally in accordance with the best interest of the customer.
4. Where the **substantive research** is commingled with other research, the investment manager should only pass on charges for the substantive research elements.
5. In disaggregating substantive research, the investment manager should consider in good faith the amount it would pay for the other research to ensure customers are not subsidising the cost of the other research.

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## DISCLOSURE

COBS 11.6.12 – 11.6.18

1. An investment manager must make **adequate prior disclosure** to customers concerning the receipt of goods or services that directly relate to the execution of trades or amount to the provision of substantive research; and
2. An investment manager must, in a **timely manner**, make **adequate periodic disclosure** of the arrangements entered into.

*This should form part of the investment manager's disclosure on inducements under COBS 2.3.1R and firms should comply with both requirements. In assessing adequacy, the FCA will have regard to the investment manager's compliance with disclosure standards developed by the Investment Management Association, the National Association of Pension Funds and the Association for Financial Markets in Europe.*

**“Prior disclosure” should:**

- Include adequate disclosure of the investment managers policy; and
- Explain why the investment manager finds it necessary or desirable to enter into these arrangements.

**“Adequate prior and periodic disclosure” must:** include details of the goods and services that directly relate to execution and separately identify the details of goods or services that are attributable to substantive research.

**“Timely manner” means:** at least once a year.

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## RECORD KEEPING

COBS 11.6.19

1. An investment manager must make a record of each prior and periodic disclosure, which it must maintain for at least 5 years; and
2. The investment manager should keep appropriate records of the basis on which it concludes that a particular good or service may be received under the exemption.

*General record keeping requirements are contained in SYSC 3.2 and SYSC 9 (as applicable).*

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## DP14/3 & MIFID II

Discussion on the use of dealing commission regime:

Feedback on our thematic supervisory review and policy debate on the market for research, July 2014

**In July 2014 the FCA published DP14/3 in relation to the use of dealing commissions and feedback from its thematic review.**

*“We have ongoing concerns about investment managers’ control over the use of dealing commissions and the conflicts of interest it creates for them as agents to their customers, given the lack of transparency of these costs. This is exacerbated by the largely unpriced and opaque market for research.”*

**DP14/3 comes off the back of the changes to COBS 11.6 details above, and the changes proposed in MiFID II to apply across the EU. It seems the future is clear:**

*“Overall, we conclude that unbundling research from dealing commissions would be the most effective option to address the continued impact of the conflicts of interest created for investment managers by the use of a transaction cost to fund external research.”*

**Level 1 proposals for MiFID II** prevent investment managers from receiving any third party inducements, with a limited exception for “minor non-monetary benefits”. It is currently proposed by ESMA that “minor non-monetary benefits” should be narrowly construed to only mean very generic, widely-distributed financial research. This would mean that value-added research currently permitted under COBS 11.6 would no longer be permitted under MiFID II.

**Comments:** The FCS is looking for responses from firms to the questions set out in Annex 1 of DP14/3 by 10 October 2014. Don't forget to have your say!

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## COMMISSION SHARING AGREEMENTS

### Pre-MiFID II

Investment managers should review their CSAs to ensure that any goods and services received meet the exception requirements in COBS 11.6.3(3), and that no prohibited goods and services are being received.

*If your CSAs go beyond generic references to “intermediary services” meaning research and/or execution services, you may wish to revise your agreements to restrict the services to substantive research only. In most cases however, a firm's CSAs should be generic enough to not require any amendment. This is distinct from reviewing and revising what is actually happening in practice and how this is recorded in order to comply with COBS 11.6.*

### Post-MiFID II

This is TBD subject to finalisation of MiFID II. However, it is likely that CSAs will either have to be substantially amended or in fact terminated.

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