Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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The use of dealing commission DP14/3

This is the Financial Services Consumer Panel's response to the Financial Conduct Authority's (FCA's) Discussion Paper on the use of dealing commission.

The Consumer Panel has consistently argued that the existence of bundling and soft commissions creates conflicts of interest between fund managers and their customers and poses difficulties for effective transparency, disclosure and accountability.

We note the efforts made by the Financial Services Authority (FSA) and its successor, the FCA, to tackle the resulting problems; first by favouring a consensual approach led by industry, later by restricting the use of dealing commission, and as recently as May this year, clarifying the legitimate expenses that can be attributed to dealing commissions. Throughout these tweaks and clarifications we argued that the crux of the issue lay in an entrenched principal/agent problem. We said that so long as the customer is not well placed to monitor the actions of the agent, there would be a diminished incentive by the agent to ensure value for money and quality.

We are pleased that the FCA is now moving closer to the Consumer Panel's long advocated solution; structural change which re-aligns the incentives by unbundling research from dealing commissions, so that investment managers would have to pay for research out of their own pocket and not charge it to the fund.

The question now is whether the FCA's preference for unbundling will provide the appropriate solution and foster culture change. Two options are proposed: one is based on the ESMA (European Securities and Markets Authority) interpretation of MiFID II, which would unbundle "non-generic" research, and the second, which the FCA proposes, is to unbundle all research[1].

[1] DP 14/3, Table 1, Page 48, Paragraph 5.38

The weakness with option 1 is the possible loophole in MiFID II. Although generally banning the bundling of execution and research, MiFID II would allow investment managers to accept "minor, non-monetary benefits" in return for commission payments. The danger is that the industry would interpret "minor" research so widely as to make the MiFID proposal ineffective. The industry's circumvention of the 2006 FSA reforms is an indication of its behaviour when presented with regulatory weaknesses.

The ESMA consultation says that minor financial research is research that *"could not be judged to impair a firm's duty to act in the best interest of their clients."* This imprecise criterion is fleshed out by ESMA, which further defines minor research as research that is generic and circulated widely. Paragraph 13, Section 2.15, of the ESMA document gives as examples: *"… simultaneously widely distributed research or information on a single financial instrument or issuer of financial instruments, or generic economic commentary ….*

Although the FCA opines that generic and widely distributed financial research has "little value", there are obvious reasons to worry that the exclusion could open up a great loophole. It is not difficult to envisage a large amount of research being regarded by the industry as MiFID II consistent and so commissionable. This is exacerbated by the lack of empirical assessment of the likely split between minor and non-minor research. The Panel believes that the solution to this problem is to regard all research as a non-minor benefit in the drafting of the MiFID II Level 2 Implementing Directive.

The second loophole applies to both option 1 and option 2. Commission is only part of the total cost of investing. What an equity research supplier loses by not being able to charge an explicit commission rate might be made up by (a) encouraging investment managers, as a means to preserve the business relationship, to turnover their equity portfolio more frequently in return for research charged at a notionally low price with a commensurate reduction in the commission rate and (b) wider spreads.

The FCA does not appear to consider the loophole that may arise from increased frequency of trading and believes that any widening of spreads would be constrained by competition. That belief requires evidential justification. Implicit bundling of research may already be part and parcel of the operation of securities markets (such as fixed income securities, currency and commodities) in which trading is typically commission-free.

The Consumer Panel believes that the current market structure is sufficiently flawed so as to require deeper structural change. The Panel's work on investment costs and charges, to be published later this year, highlights as possible options for reform improved, embedded governance of investment managers and the banning of the practice of charging any cost to the fund. Such reforms may well be required to achieve the desired outcome of transparency and improved disclosure and effectively to address conflicts of interest.