

## Discussion Paper

10/10/2014

### FCA DP Dealing Commission

- 1 The Association for Financial Markets in Europe ("AFME") welcomes the opportunity to comment on the Financial Conduct Authority's discussion paper DP 14/3 on the use of dealing commission regime (the "Discussion Paper" or "DP"). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, and sustainable European financial markets that support economic growth and benefit society.
  - 1.1 AFME is the European member of the Global Financial Markets Association ("GFMA") a global alliance with the Securities Industry and Financial Markets Association ("SIFMA") in the US, and the Asia Securities Industry and Financial Markets Association ("ASIFMA") in Asia.
  - 1.2 AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.
  - 1.3 This response has been developed with input from the British Bankers' Association and its members.

## 2 The Discussion Paper and our response thereto

- 2.1 In the Discussion Paper, the FCA asks for (i) comment on the FCA's analysis of the potential impact of unbundling payments for research from execution arrangements, based on MiFID II proposals; and (ii) analysis on possibly extending the requirements in MiFID II to cover all research goods and services.
- 2.2 AFME notes that the "MiFID II proposals" referred to in the Discussion Paper, on which the FCA bases much of its argument and which it supports, are ESMA's proposals and draft technical advice, set out in section 2.15 of ESMA's recent consultation paper on proposals for MiFID II Level 2 measures (the "Consultation Paper" or "CP")<sup>1</sup>. ESMA received a very large number of comments on this section, most of which, like AFME's, highlighted the potential negative unintended consequences of the proposals. We believe it would be premature to assume that ESMA's proposals will be adopted in their entirety.
- 2.3 Even ESMA's own Securities and Markets Stakeholder Group ("SMSG") recommended that the section regarding investment research be deleted, stating, *inter alia*

"....the SMSG completely disagrees with the qualification of research as an inducement, and does not even see it as being a non-monetary benefit. It notes that the Level 1 text never considered investment research as an inducement and logically never directed either the Commission or ESMA to work in this direction. Research is not an inducement for the distributor, but an additional service that is aimed for the benefit of the client...."

".....the same applies to tailored research which is to the benefit of a specific fund or a specific portfolio. Such tailored research does not give an advantage to the portfolio manager but to the portfolio and hence the client. Therefore it cannot be regarded as benefit for the portfolio manager."

"....ESMA's interpretation would also prohibit face to face meetings between investment firms and analysts to discuss investment ideas which should be encouraged rather than discouraged, since this would promote out of the box thinking, honest and candid discussions, and is currently a common market practice."

".....according to the Consultation Paper, only "minor" benefit could be paid via commissions and it defines minor benefits in the area of financial analysis as research of general content, widely

<sup>1</sup> ESMA/2014/549

distributed i.e. equivalent to newspaper articles. This type of research is of no value and is never paid for by fund managers which are capable of reading annual reports<sup>2</sup>

- 2.4 We also note that the political compromise at Level 1 of MiFID II did not require a de facto ban on inducements in the context of independent advice, as stated in a press release of the CSU rapporteur in the EU Parliament, Markus Ferber MEP, who has taken the view that ESMA's draft advice goes beyond Level 1, a view with which we respectfully agree.<sup>3</sup>
- 2.5 We share the FCA's desire to ensure that end investors are protected from the effects of potential conflicts of interest in the equity market but we are concerned about the unintended consequences that might result from the FCA's proposals as set out in the Discussion Paper. Given the uncertainties around the outcome of ESMA's deliberations we feel it is worth reiterating the salient points we made in our response to them, all of which we regard as still valid, together with such additional points as we deem appropriate. The analysis in Appendix 1 also addresses the FCA's request for comments on its analysis of the potential impact of unbundling payments for research from execution arrangements. We have not addressed the FCA's second question (regarding the potential impact of requiring all research, however minor, to be paid for directly by investment managers) in any detail since we believe the main concerns we have regarding unintended consequences would apply under either of the FCA's proposed regimes.
- 2.6 Based on the above and as detailed in Appendix 1, we oppose the FCA and ESMA proposals to prohibit the use of dealing commission to purchase research.
- 2.7 The key remaining issue is the requirement that conflicts of interest be properly and fairly managed. In the case of equities research we believe this can be done via commission sharing agreements and research purchase agreements, as set out in Appendix 1. In the case of non-equity research, which is alluded to in passing in the DP but not referred to in any detail, we believe that no proper analysis has been done by either ESMA or the FCA; the subject does not fall within the scope of the DP and, while we agree it should be looked at, this needs to be done properly, with full consultation and cost-benefit analysis, at some point in the future. AFME would be happy to participate in that process.
- 2.8 Notwithstanding that, for the reasons given above, we have not addressed in this response each and every argument made by the FCA in the DP, we do note that the DP casts doubt on the effectiveness of commission sharing agreements. In view of this we summarise below the main points made by the FCA in this regard together with our comments thereon.
- 2.8.1 The FCA suggests that CSAs are complex to create and administer. We disagree. The prevalence of CSAs in the UK and US shows that they can be created and operated efficiently and inexpensively<sup>4</sup>.
- 2.8.2 The FCA suggests that brokers that use CSAs thereby acquire an unfair competitive advantage which helps them attract more order flow than brokers who do not use CSAs. Again we disagree. Investment managers are free to trade with any party and are obliged to seek best execution. It is true that they tend to have CSAs with larger trading parties so as to ensure that research payments are made, but this we see as a correlation between trading volumes and the use of CSAs, not a constraint on competition.
- 2.8.3 The FCA states that CSA payments are sometimes withheld. While we do not know if this is or is not the case, we can say that to do so without good cause would be a breach of the CSA and could therefore be pursued through the courts. This is not a problem of CSAs per se, but of breach of contract.

---

<sup>2</sup> ESMA/2014/SMSG/035

<sup>3</sup> [http://www.markus-ferber.de/verschiedenes/presse-aktuell-single-view/?tx\\_ttnews\[tt\\_news\]=2296&cHash=8ba1320b11245451d167162e31cd7c49](http://www.markus-ferber.de/verschiedenes/presse-aktuell-single-view/?tx_ttnews[tt_news]=2296&cHash=8ba1320b11245451d167162e31cd7c49)

<sup>4</sup> CSAs are used extensively in the UK. A Greenwich Associates census (Greenwich Associates 2014 European Equity Investors Research Study) of UK asset managers over the 2011-2014 period, demonstrates that over 70% have CSA arrangements in place.

- 2.8.4 The FCA states that CSAs provide competitors with information on each others' research payments. This issue can be managed, like many information management issues within regulated entities, by information barriers between CSA administrative staff and other staff of the entity concerned.

### 3 Inconsistency with Her Majesty's Government strategy

- 3.1 Finally, given what we have set out in Appendix 1 below about the likely effect of the proposals set out in the CP and DP on the EU and UK investment management industry and on the inconsistency of the proposed UK/EU regulation with that elsewhere, notably the US, we would comment that the DP appears to be inconsistent with HMG's strategy for the UK investment management industry, which was launched in March 2013 by the Chancellor of the Exchequer<sup>5</sup> with the following words (emphasis added).

*"The UK investment management industry serves millions of customers all around the globe generates around 1 per cent of GDP and employs tens of thousands of people across the UK. As part of this Government's objective to equip the UK for success in the global race, I am committed to making the UK one of the most competitive places in the world for the investment management sector.*

*Whilst the UK remains Europe's leading centre for fund management, our share of fund domicile has fallen in the last decade. This document identifies the key challenges and opportunities we face in reversing this trend. We must act now to rebuild our share of this global business, to take advantage of growth opportunities in Asia and to respond to changes in European regulation. This report sets out the steps we are taking as part of a comprehensive strategy to achieve this aim. We will focus on three main areas:*

1. *Taxation: we will work hard to ensure our tax regime is simple, fair and streamlined.*
2. *Regulation: we will ensure a regulatory environment that applies high internationally consistent regulatory standards and that remains responsive.*
3. *Marketing: we will work closely with key industry bodies to carry a co-ordinated marketing approach to all corners of the globe."*

### 4 European Consistency

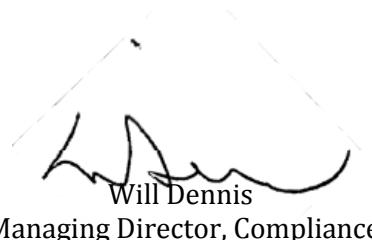
- 4.1 We presume that the FCA will review its proposed policy on the use of dealing commission in light not only of the responses to this DP, but also of ESMA's final technical advice to the European Commission, as well the latter's consideration of this advice as it develops draft implementing legislation on this issue. We note in this context the FCA support for an EU wide approach, as indicated in the DP and most recently confirmed at the 18 September FCA conference on MiFID where Maggie Craig (FCA Acting Head of Savings & Investments) acknowledged that the use of dealing commission '*...will be subject to further intensive debate at ESMA...' and that '...it remains our preference for any further UK changes to be in step with the final EU-wide approach'*'.

- 5 Given the complexity and breadth of the DP, we may follow up with further comments.

Yours truly,



Christian Krohn  
Managing Director, Equities



Will Dennis  
Managing Director, Compliance

<sup>5</sup> 'The UK investment management strategy, March 2013'

## **Appendix 1**

Salient points of AFME's response to section 2.15 of ESMA CP ESMA/2014/549

### **1.1 Research is not an inducement**

AFME supports the idea of clear rules on inducements, with a view both to increasing transparency for end investors and to facilitating effective conflicts management by portfolio managers. However, the provision of investment research is not an inducement.

### **1.2 Research is a service that is charged and paid for**

- 1.2.1 Both the FCA and ESMA appear to predicate their argument on the assumption that investment research is a benefit, and therefore an inducement that portfolio managers are barred from receiving except when it is of a minor nature. We fundamentally disagree with this view.
- 1.2.2 The provision of investment research, as a matter of law, is a service; it is explicitly included as such in Annex I of MiFID II. Provision of research by a MiFID firm also requires that the recipient becomes a client of the research provider (art. 4(9) MiFID II). In that respect, it is no different from other investment services, which are purchased by the portfolio manager on behalf of its funds, for the benefit of the underlying asset owner.  
The prohibition on receipt of non-monetary benefits cannot be interpreted as a prohibition for the receipt of investment services, activities or ancillary services (as defined in Sections A and B of Annex I of MiFID II) when those services are paid for at arm's length and for full value.

### **1.3 Portfolio managers may purchase research from brokers at arm's length and for full value**

- 1.3.1 As paragraph 15 of ESMA's introduction to its draft technical advice correctly identifies, the prohibition on the receipt of non-minor inducements does not prohibit portfolio managers from purchasing research directly on behalf of their client from a broker or a third party, as long as there is a clear and separate contractual agreement between themselves and the broker or third party. We support this view and have suggested that this be clearly stated in the draft technical advice (please see suggested drafting below). As outlined below, we propose that this could be achieved via the widespread adoption (or even the making mandatory) of Commission Sharing Agreements ("CSAs"), combined with pre-determined advisory budgets set out in contracts for provision of research providing full transparency as to the basis on which expenditure will be made.
- 1.3.2 As for other services, the portfolio manager may arrange for a fund to purchase the service and the fund will then consume the service, and benefit from it via the portfolio manager; this is a practical necessity given the fact that the fund itself is a legal construct with no personnel, so has to rely on the portfolio manager to avail itself of the service.
- 1.3.3 AFME agrees with ESMA and FCA that, as for other services, the portfolio manager or independent adviser would need to ensure that the terms of such arrangements are not influenced by other services they acquire directly on behalf of their clients from the same third party, and would be subject to all other conduct of business rules, for example on the management of conflicts of interest.
- 1.3.4 As some European regulators have noted, current market best-practice arrangements for paying for research in some countries (the UK, France and several other EU member states) provide a cost-effective and transparent mechanism, utilising CSAs, to satisfy the requirements in this section. We explain how these work below. With the improvements that we suggest, we are confident that, if similar arrangements were recommended or made mandatory by regulators across Europe, the policy objective of separating decisions and payments regarding execution from decisions and payments regarding research would be achieved in a way that maximises benefit and minimises costs for end investors in the funds that are the portfolio managers' clients.

**1.4 ESMA's (and FCA's) erroneous contention that when research is provided at an undervalue it may be an inducement and, if so, can only be received by a portfolio manager if it is a minor non-monetary benefit.**

- 1.4.1 When the portfolio manager avails itself of materials that are generally available then the materials are not capable of being an inducement, because there is no link between the availability of the materials and the purchase of other services from the research provider.
- 1.4.2 There is an additional, theoretical possibility which we should deal with, which is that when research that is not generally available is provided at an undervalue, then it could be an inducement and, therefore, portfolio managers would only be able to receive it when it is a minor non-monetary benefit.
- 1.4.3 Minor non-monetary benefits must be: capable of enhancing the quality of service provided to a client; and of a scale and nature that could not be judged to impair compliance with the portfolio manager's duty to act in the best interest of its clients.
- 1.4.4 This will depend on the circumstances in each case, so we consider it helpful that ESMA decided to include financial research in its list of minor non-monetary benefits and would suggest that, in the interests of clarity, it be separated from information on financial instruments.

**1.5 Quality enhancement**

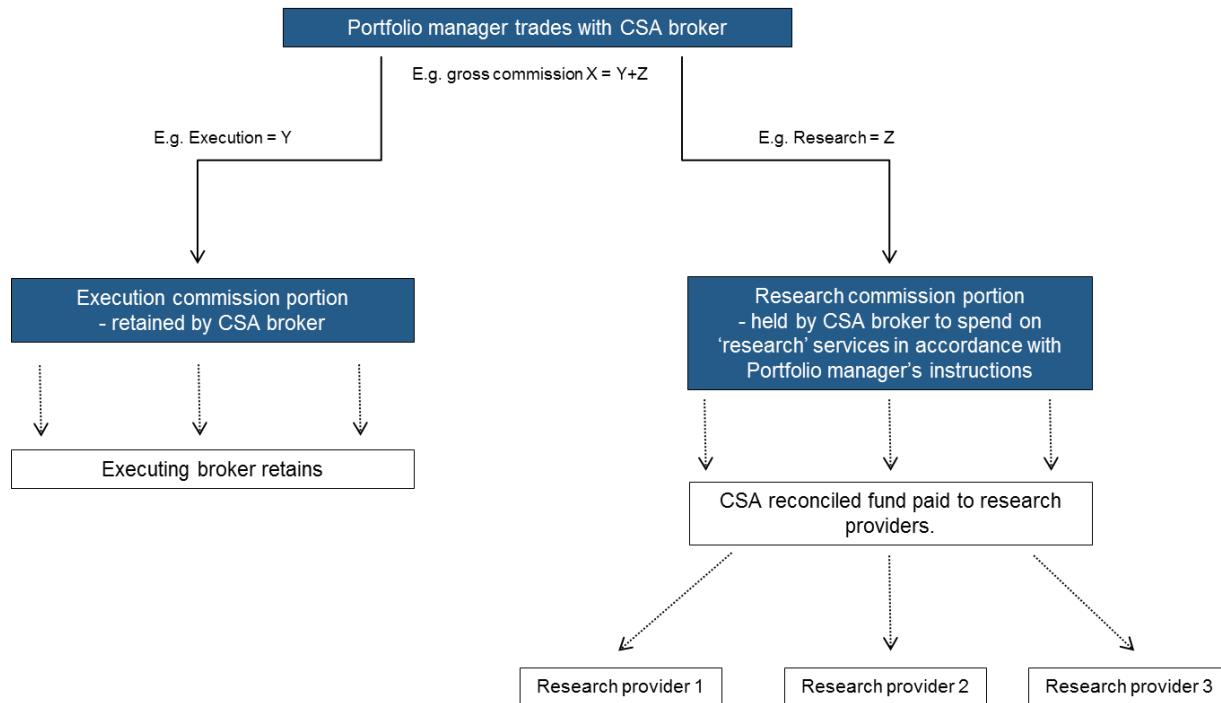
In relation to the quality enhancement requirements, we agree that an investment firm cannot purport to receive a benefit from a third party as a permissible inducement, if that benefit is a service that the investment firm itself was expected to perform. It is important, however, to differentiate between core and non-core services, which appears also to be supported by ESMA in the use of the word "essential" in the draft technical advice paragraph 10(i). Clarifying therefore that ancillary services are non-essential would be a useful enhancement to the proposed technical advice, and we provide a drafting suggestion at appendix 2 below.

**1.6 Example of arrangements where research is paid for at full value and at arm's length**

- 1.6.1 Any proposed solution must address the objective stated by ESMA in paragraph 2.15 "The portfolio manager or independent adviser would need to ensure that the terms of such arrangements with a third party are not influenced by other services they acquire directly on behalf of their clients in their provision of independent investment advice or portfolio management services where they acquire these from the same third party." The FCA also makes this point in the DP
- 1.6.2 The amendments to the draft technical advice that we have proposed and the objective of paragraph 15 would be satisfied through the establishment of a mechanism for receipt and payment for research which consists of:
  - (i) CSAs for portfolio managers signed with executing brokers; combined with
  - (ii) ex-ante contracts between managers and research providers covering the provision of research services (including generic methodology where such is paid for on an ex-post basis).
- 1.6.3 This mechanism allows the portfolio manager completely to disaggregate the decision as to where to purchase execution, from the decision where to purchase research. It also provides transparency and complies with the requirement to disclose the price of separate services that are provided together by the same investment firm (Art. 24(11) MiFID II). It is important to note that the portfolio manager is not required to purchase research services from the broker it uses for execution services. The portfolio manager can use the commission credits it has accrued to purchase research services from any of the research providers, and can indeed decide to stop paying the research portion of the commission once it considers it has accumulated a sufficient amount of research credits for the period in question.

- 1.6.4 We have provided below an explanation of the CSA model which is currently widely used by the majority of major European portfolio managers.

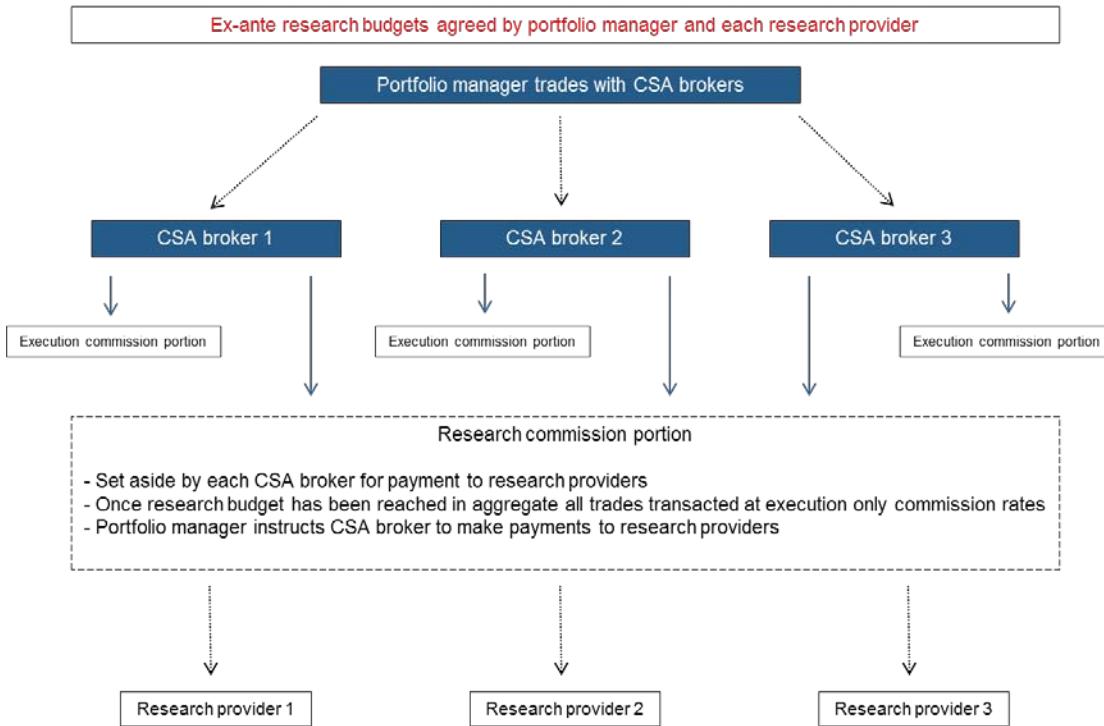
Current CSA Model



- 1 Portfolio manager trades with executing broker on behalf of fund. The choice of executing brokers may differ from the choice of research providers. Executing brokers are chosen by portfolio managers on the basis of criteria relevant for best execution, whereas research providers would be chosen on the quality of their research.
- 2 Fund (acting via the portfolio manager) pays a gross commission rate to the executing broker, the portfolio manager stipulating clearly which portion of that commission is for execution services and which is to be set aside for the payment of research providers.
- 3 Once the research budget is reached in aggregate across the CSA accounts, all subsequent trades are transacted at execution-only rates.
- 4 Payment for research services is determined by portfolio managers on the basis of the quality of research service they have received. The portfolio manager instructs the CSA broker on a regular basis (e.g. quarterly, semi-annually) to make payments to the research providers. One way in which this happens currently is based on a broker vote, which ranks the quality of research provided to the portfolio manager.

- 1.6.5 To improve current practice further, and also to provide greater transparency, we propose the use of ex-ante contracts for the generic provision of research between portfolio managers and research providers, as described above. This is in line with paragraph 15 of Section 2.15 of the ESMA CP and, when the research provider is a broker, also complies with the requirement to disclose the price of separate services that are provided as a combination by the broker (MiFID II Article 24(11)). We show the proposed enhancement in the diagram below.

Proposed Enhanced CSA Model



## **1.7 List of positive indicators of quality enhancement**

We think that a non-exhaustive list of positive indicators of quality enhancement would be more compliant with Level 1 than ESMA's current proposal, as the requirement in Article 24(13)(d) is for the European Commission to provide criteria to assess compliance with the inducements prohibition, not non-compliance. We would therefore suggest removing paragraph 11 and redrafting paragraph 10 as follows:

"A fee, commission or non-monetary benefit will generally be regarded as designed to enhance the quality of the relevant service if it has one or more of the following characteristics:

- i. It is used by the recipient firm to provide for an additional or higher quality service to the end client that goes beyond the relevant minimum regulatory requirements (including any ancillary services in Section B of Annex I which are non-essential for the provision of the investment services and activities of Section A of Annex I of MIFID II);
- ii. It is used by the recipient firm to provide goods or services that extend its offering beyond what it would be expected to provide in the ordinary course of business;
- iii. It delivers value or a tangible benefit to end users and clients of the recipient firm;
- iv. It enables the end user to access a wider range of financial instruments or services that would otherwise be available, for example by enabling the provision of non-independent advice on an ongoing basis, so long as any such service or instrument is provided without bias or distortion as a result of the fee, commission or non-monetary benefit being received.

ESMA may also add to these characteristics by developing ESMA guidelines and recommendations."

## **1.8 Negative economic and anti-competitive consequences of the ESMA CP / FCA Discussion Paper**

- 1.8.1 If research cannot be paid for via dealing commissions, we expect there would be significant and negative consequences on fund interests and returns. Research services constitute valuable services to portfolio managers and funds, because they enable portfolio managers to make better investment decisions, which ultimately benefit the fund. If research cannot be paid for via dealing commissions, there will be substantial international divergence as to how research costs are charged and disclosed in the EU to the detriment of European portfolio managers, whose annual management charges will be inflated compared to non-EU portfolio managers, hence adversely biasing the comparability of their services' costs and accordingly affecting consumer investment decision and choice, especially in the case of global mandates.
- 1.8.2 The portfolio manager would need to find an alternative way of paying for research services. This could include one or more of: increasing its management fees to cover the costs; paying for research via its own operating expenses; or charging funds separately for research.
- 1.8.3 Some of the potential costs and detrimental consequences to funds are outlined below.

## **1.9 Less diverse research coverage**

- 1.9.1 Service providers may choose to restructure their businesses and concentrate resources on the production of research on blue chip companies, as opposed to small and medium enterprises. This could potentially result in less unique and contrarian research being produced, whilst leading to a reduction of the coverage universe. This reduction of coverage would result in a less well informed market and could ultimately impact small and medium European enterprises as they seek to grow through raising capital; less research coverage is in turn likely to result in less investment in these enterprises by European portfolio managers.
- 1.9.2 A similar effect is likely to be seen on emerging markets research. Both small/medium-sized enterprise ("SME") coverage and emerging markets research coverage tend to be provided by specialist/local analysts. A move in the market to favour larger research providers, which are able better to absorb the increased operating costs, would see fewer small independent research providers covering these areas,

which will likely be considered unprofitable. The current provision of research coverage of small and medium sized companies is already limited. Euronext<sup>6</sup> estimates that 40% of the 220 TMT shares listed on their four main European markets – Amsterdam, Brussels, Lisbon and Paris – currently have no sell-side analyst coverage. There is a significant body of academic work that shows that sell-side research coverage improves firm valuations<sup>7</sup>, enhances stock liquidity<sup>8</sup>, and reduces the cost of equity<sup>9</sup>. If sell-side research budgets are cut due to the ESMA/FCA proposals it seems unlikely that there would be any expansion of research coverage to companies not already followed by analysts.

- 1.9.3 Much of the research coverage of SMEs is provided by local brokers as well as small boutique and independent research providers who receive a significant proportion of their payment for their research through CSAs. Without such arrangements being available we believe much of this research will disappear.
- 1.9.4 Mola, Rau and Khorana, 2012<sup>10</sup> have published an extensive analysis of the impact on companies that lose sell-side research coverage for extended periods of time. They highlight ‘significantly lower trading volumes and turnover ratios and significantly higher bid-ask spreads and book-to-market ratios than peers’. They also observed that firms that lose coverage for four years or more are more likely to delist (61%) than comparable firms where research coverage is maintained (51%). This is supported by academic work done by Weild and Kim, 2009<sup>11</sup>, which shows that the number of firms listed on US public exchanges has dropped over 20% from about 7000 firms in 1991 to less than 5400 firms in 2009 due at least in part to analysts ceasing to cover small and mid-cap stocks. It should also be noted that equity markets are a key route for growing firms to access new capital.
- 1.9.5 Due to the cyclical nature of sectors and geographical regions, firms currently maintain a service covering of areas that may not at a specific point in time (for example in a downturn) be a key area for investment by portfolio managers. However, the advantage of maintaining consistent coverage in these areas for the end investor is that when the area in question does become a viable investment opportunity then there is still valuable research and expertise available. Under the new proposals, research providers would be less able and less likely to maintain continuous coverage and due to the nature of research production (expertise is built up over a period of time as opposed to acquired instantaneously) are unlikely to be able to suddenly cover such areas.
- 1.9.6 Removal of incentives to improve the quality of advisory resources (as a consequence of the reduction in the open, competitive nature of the market for research advice) would also result in a lower quality of research available to portfolio managers, and ultimately lead to less well-considered investment decisions for investors.

## 2 Procurement of US research

- 2.1 UK and other European portfolio managers and their clients will be disadvantaged relative to portfolio managers and clients in other jurisdictions because US brokers may refuse to provide them with bespoke or other valuable research in exchange for cash payments. This is because of uncertainties under US investment adviser law when so doing. While some major US broker-dealers are also registered as investment advisors, their research analysts are not considered investment advisors. Though the SEC staff has provided limited no-action relief in this area, the relief is unworkable given practical realities. As a result of these regulatory concerns, most major US brokers do not generally accept cash payments for research. Even if US brokers were willing to accept cash payments and submit to investment advisor regulation over their research, US laws governing investment advisers would result in these brokers limiting their transactions with European portfolio managers and their clients to agency transactions. This would deprive European investment managers and their clients of capital

<sup>6</sup> <https://www.euronext.com/en/news/enternext-boasts-sme-equity-research-and-supports-technology-sector-two-initiatives>

<sup>7</sup> Bradley, Jordan and Ritter, 2003

<sup>8</sup> Irvine, 2003

<sup>9</sup> Baker, Nofsinger and Weaver, 2002

<sup>10</sup> Is There Life after the Complete Loss of Analyst Coverage? by Simona Mola, P. Raghavendra Rau, Ajay Khorana <http://ssrn.com/abstract=1573309>

<sup>11</sup> [http://www.grantthornton.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/gt\\_wakeup\\_call.pdf](http://www.grantthornton.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/gt_wakeup_call.pdf)

commitment, volume-weighted average price (VWAP) and other transactions effected on a principal basis via a broker providing the research, and also of investments sold on a dealer-only basis, thus forcing those European managers and their clients into the possibly less favourable agency markets for those investments and, therefore, potentially jeopardising best execution.

- 2.1.1 If UK and other European portfolio managers could not pay for US research from commission due to a prohibition under UK/European regulation, and US broker/dealers could not in practice accept payments for research under US law, this would make it impossible for a European-based investment manager to procure US research, which in turn could result in UK/European portfolio managers being unable to procure US research other than from registered investment advisers or European producers of US research. This could lead to a significant reduction in choice of the research being procured on behalf of the end investor.
- 2.1.2 This would also make it less economically viable for UK/European firms to publish research on US companies or macro-economics; meaning less US research, at higher costs, for UK/European consumers and potentially poorer performance for UK/European portfolio managers managing US assets. As a consequence, it would be more difficult for UK/European investors to access US markets, given that European portfolio managers will reduce US mandates under management. UK/European consumers will be left with less choice of funds providing exposure to US markets, and with higher risk, as most of the investment options available will be managed by US managers, thus leaving those UK/European consumers without the protection of the UK/European regulatory regime.

## 2.2 Competitive advantage to non-European portfolio managers

- 2.2.1 Given that research is an essential service assisting portfolio managers in the performance of their core function and that research, like execution, is a service used for the benefit of the fund rather than the portfolio manager, the cost of research is likely to be passed on to funds, probably through the annual management charge ("AMC").
- 2.2.2 Analysis of the UK market suggests that the increase in the AMC arising from incorporating the cost of research could be in the region of 7bps, rising to 9bps if research payments are subject to VAT (which is likely to be charged on explicit separate payments for research, at least in some jurisdictions, including the UK, in a way that dealing commissions are not)<sup>12</sup>. This figure is based on the AMC increase being the same as an implied research payment of £1.04bn (£1.25bn with VAT) divided by the estimated active equity mandate assets under management (AUM) of £1,463bn. A worked calculation is below:

AUM (end 2012)	£4,459 bn	(IMA Annual Survey 2012-3)
Equity content	42%	(IMA Annual Survey 2012-3)
Implied equity assets	£1,873 bn	
Active	78%	(IMA Annual Survey 2012-3)
Active equity AUM	£1,463 bn	
Turnover	1.2 xs	
Commission rate	11bps	(Greenwich Associates European Equity Investors 2013)
Implied commissions	£1.93 bn	
Research allocation	54%	(Greenwich Associates European Equity Investors 2013)
Implied research payment/ Increased AMC	£1.04 bn, or 7bps on £1,463bn	
VAT on which @ 20%	£0.21 bn	
Total implied research Payment/increased AMC	£1.25 bn, or 9bps on £1,463bn	

- 2.2.3 In theory, the impact of moving research costs from dealing commission to AMC should be neutral to the end investor. But investors, and retail investors in particular, focus on AMCs when comparing

---

<sup>12</sup> BofA Merrill Lynch global research, "Commission Unbundling – the European Dimension", 12 June 2014.

relative costs of portfolio managers and often use these as the key point of comparison between portfolio managers. As a result, it would appear to investors that a European portfolio manager running an identical fund to a US portfolio manager is charging a higher AMC, thus placing European portfolio managers at a competitive disadvantage. Furthermore, the gap in AMCs charged by actively-managed funds would widen as compared with passively-managed funds.

- 2.2.4 Given that investors are naturally very focused on driving costs down (and in some cases have a fiduciary or legal duty to demonstrate such a focus on costs) there would be a strong incentive to switch their funds away from European portfolio managers to US portfolio managers, where the management fees are likely to be lower.
- 2.2.5 There would also no longer be a common point of comparison between the relative costs of portfolio managers on a global basis; European portfolio managers' costs methodologies will be out of step with the way the rest of the world both charges and discloses costs. Given that this will be a competitive advantage to non-European portfolio managers, there will be little incentive for non-European jurisdictions to change their regulatory regimes so that they are in line with that of Europe. Contrary to what the FCA suggests in the DP, there has so far been no indication that other jurisdictions are considering changing the way that their portfolio managers pay for research, and we note that such change would require significant political motivation to do so given that it would require legislative change in, e.g., the US.
- 2.2.6 This will make it difficult for European portfolio managers to compete in the international marketplace, particularly for international mandates, and would likely result in a reduced choice of funds and portfolio managers available to the European consumer. Portfolio managers that manage products out of both the Europe and the US will likely move operations to the US, given the competitive advantage of doing so. EU-managed products may also be less attractive to US consumers, as a consequence of higher headline costs.

### **2.3 Disproportionate impact on smaller portfolio managers**

- 2.3.1 The current system has low barriers to entry for new/small portfolio managers. By contrast, FCA's and ESMA's proposals would erect considerable barriers to entry in the form of the high start-up costs which would result from paying for research out of profit and loss.
- 2.3.2 The combined effect of raising barriers to entry for smaller portfolio managers, and of encouraging funds (including very large pension funds and sovereign wealth funds) to switch their funds to non-EU portfolio managers to avoid apparently higher fund management fees, is likely to have a materially detrimental impact on investment within the EU and consequently upon economic growth in the region, as well as reducing customer choice.

## Appendix 2

### Proposed amendments to ESMA's proposed technical advice

#### *Accept and not retain third party payments*

[...]

3. Investment firms providing the service of independent investment advice and portfolio management are not allowed to receive non-monetary benefits that do not qualify as minor. In this context, a non-monetary benefit is any service received for free or at an undervalue by the investment firm which provides the service of independent investment advice and portfolio management. Non-monetary benefits do not include any services or activities in Sections A and B of Annex I of Directive 2014/65/EU which are received and paid for at arm's length by the investment firm on its own behalf or on behalf of its clients, whether through dealing commissions or out of the investment firm's own resources.

#### *Minor non-monetary benefits*

4. ESMA advises the Commission to introduce a non-exhaustive list of non-monetary benefits that can be considered to be minor and are therefore acceptable. All such benefits should only qualify as minor when they are reasonable and proportionate and of such a scale that they are unlikely to influence the recipient's behaviour in any way that is detrimental to the interests of the relevant client.

5. This list should include the following benefits:

i. Information or documentation relating to a financial instrument (including financial research) or an investment service; This information could be generic in nature or personalised to reflect the circumstances of an individual client;

ii. financial research (including research on financial instruments or issuers, as well as sectoral and economic research);

iii. participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service; and

v. hospitality of a reasonable de minimis value, this could for example include food and drink during a business meeting or a conference, seminar or other training events mentioned under iii.

6a. Minor non-monetary benefits as defined above should be clearly disclosed by investment firms before providing investment or ancillary services to clients.

6b. Material that is generally available to all without a fee, for example a free broadcast or an article published on a website that is free to access, is not capable of being an inducement.

6c. For the avoidance of doubt, it should be clear that the prohibition on the receipt of non-minor inducements does not prohibit portfolio managers, whether acting for themselves or on behalf of their clients (i.e. the funds they manage) from purchasing goods and services, including research, from a broker or a third party as long as there is a clear and separate arm's length contractual agreement between themselves and the broker or third party.

## Association for Financial Markets in Europe

London office:

St Michael's House  
1 George Yard  
London EC3V 9DH  
Tel: + 44 (0)20 7743 9300

Brussels office:

Square de Meeûs 38-40  
1000 Brussels  
Belgium  
Tel +32 (02)2 401 8724

[www.afme.eu](http://www.afme.eu)