February 25, 2014

Via Electronic Mail

Adam Wreglesworth
Wholesale Conduct Policy & Client Assets
Markets Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Re: FCA Consultation Paper CP13/17 (November 2013)

Dear Mr. Wreglesworth:

The Investment Adviser Association (IAA) appreciates the opportunity to comment on Consultation Paper 13/17, relating to the use of dealing commission rules.[1] The IAA is a not-for-profit US association that represents the interests of investment adviser firms registered with the US Securities and Exchange Commission (SEC). Our membership consists of investment advisory firms that manage assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment funds, endowments, foundations, and corporations, and many of our members manage, or have affiliates that manage, assets for UK clients.[2]

Investment advisers in the US are subject to a fiduciary standard in the management of their clients' assets, which encompasses the important principles of trust, loyalty, and duty of care. Our members must act in the best interests of clients and place the interests of clients before their own. This duty is over-arching and includes transparency, particularly the duty to disclose, among other things, potential conflicts of interest that may arise in the course of their services. We therefore support transparency in advisers' dealings with clients. We have concerns, however, about the specific changes proposed in the Consultation Paper, including whether they would ultimately benefit clients.

[1] FCA Consultation Paper, CP13/17 (November 2013) (Consultation Paper).

[2] For more information, please visit our website: www.investmentadviser.org.

Introduction

The Consultation Paper discusses proposed changes to the Conduct of Business sourcebook (COBS) that would amend the rules governing the use of dealing commission by investment managers. Under the current version of COBS 11.6, an investment manager generally cannot accept additional goods or services in connection with the execution of client orders. The COBS includes an exemption from the general rule, however, for goods or services "if the investment manager has reasonable grounds to be satisfied that the goods or services received in return …comprise the provision of research" and "will reasonably assist the investment manager in the provision of its services to its customers on whose behalf the orders are being executed and do not, and are not likely to, impair compliance with the duty of the investment manager to act in the best interests of its customers."

The changes proposed in the Consultation Paper would alter significantly an investment manager's analysis of its use of dealing commission in a number of ways, and extend far beyond the treatment of corporate access and market data services, which are highlighted in the Consultation Paper. Our comments primarily relate to (1) the proposed elimination of the "reasonable grounds" standard under which investment managers currently assess the permissibility of the use of client dealing commission under COBS 11.6.3R; and (2) the implications of the proposed changes for investment managers that do business on a global basis.

Elimination of the "Reasonable Grounds" Standard

We are concerned about the implications of the proposed elimination of the "reasonable grounds" standard and the substantial change that this amendment would represent. As noted above, the current COBS provides that the research exemption applies "if the investment manager has reasonable grounds to be satisfied that the goods or services received in return …comprise the provision of research." Under the proposed new formulation, the reference to "reasonable grounds" would be eliminated, and a form of strict liability could be imposed on investment managers that made an incorrect determination of the eligibility of a particular good or service for the exemption, regardless of the good faith of the manager or the grounds for its determination.

The IAA views this elimination as a substantial change that goes well beyond the clarification of existing rules. The body of the Consultation Paper does not discuss or explain the reasoning behind the elimination of this language. Given the broad variety of goods and services that could potentially constitute research under COBS 11.6.3R, and difficulty of drawing a bright-line between permitted research and other goods and services that do not fall

within the exemption, a strict liability standard would not be appropriate in this context.[3] Furthermore, the proposed changes would establish a presumption that a specific use of dealing commission was not exempt. The Consultation Paper explains that "[t]his would clarify the perimeter of the regime by introducing a presumption of a breach of the rules if the cumulative criteria are not met." Adding this presumption to the elimination of the reasonable grounds standard would establish unwarranted barriers to investment managers' access to research, and could raise the fees paid by UK clients if managers passed on the cost of research. The changes would be especially far-reaching when combined with other proposed changes to the COBS.

Corporate Access

For example, the proposed inclusion of corporate access services in the list of examples of services that do not constitute research would require an investment manager to determine whether a particular service constituted a "corporate access service." This term would be defined in the proposed changes as "a service of arranging or bringing about contact between an investment manager and an issuer or potential issuer." In its discussion of corporate access services in the body of the Consultation Paper, however, the FCA notes that broker research offered in addition to the arranging service ("such as a briefing note or a research analyst's input before a meeting") "may be capable of being reasonably judged by the investment manager as chargeable to dealing commission under the exemption." Under the strict liability that the proposed revisions to the COBS could impose if adopted unchanged, the investment manager would designate this aspect of the service as constituting research at its own peril in the event that the FCA ultimately disagreed, regardless of whether this analysis had been undertaken in good faith and the investment manager had reasonable grounds to reach its conclusions. This change would have real practical consequences, for example, for broker-arranged events and meetings such as non-deal roadshows and conferences that may have heavy broker research content throughout, but also involve meetings with company management.

Proposed New COBS 11.6.8A

The elimination of the "reasonable grounds" standard and the presumption of breach of the rules could also impact the investment manager's duties under the proposed new COBS 11.6.8A. This provision would alert managers that in using dealing commission for research services they should (1) compare the costs to what they would pay directly for such services; (2) negotiate or dictate the price of the good or service, if in a position to do so; and (3)

[3] We note that the US statute governing the use of "soft dollars," section 28(e) of the Securities Exchange Act of 1934, uses a "good faith" standard in describing the required determination on the part of an investment manager that the amount of commission is "reasonable in relation to the value of the brokerage and research services provided" in a similar context. *See* 15 U.S.C. § 78bb.

disaggregate various services in the "mixed use" context. All of these undertakings would necessitate access to information about the costs of such services, but some of this information might not be available to the manager, especially in the context of the "mixed use" analysis of corporate access and market data services.

For example, this proposal incorrectly assumes that there is an established market for every service with a "hard" cost, and that brokers are willing to provide this information. This misconception is particularly significant in the context of corporate access services, but applies in other contexts as well, especially as to proprietary research. Managers would face difficulties in documenting compliance with these requirements, because brokers do not have an established means for valuing corporate access and/or research. In addition, some brokers may not cooperate in providing a value or even accept payments from an investment manager's own resources for such services. Even if brokers provided estimated prices for these services, prices among brokers would inevitably vary, depending on the methodologies and assumptions underlying the estimates.

Further, investment managers would face substantial challenges in documenting whether and to what extent they are in a position to negotiate with brokerage firms. Here too, investment managers that undertake these analyses, which would require extensive data-gathering and recordkeeping, would face heightened liability risks under the proposed changes to the COBS, if the FCA disagreed with their analysis. In addition, the cumulative effect of these changes could require investment staff to spend a disproportionate percentage of their time on documentation of limited utility, to the detriment of their investment research and analysis. While we understand the FCA's intent in ensuring that managers "seek to control costs to clients with as much rigour as they pursue investment returns," we submit that a client who hires an investment manager would prefer that the manager focus primarily on delivering strong investment performance (including performance net of costs, a calculation that already provides managers with strong incentives to control costs).

In addition, we note that the cost-benefit analysis of the proposed changes does not discuss the impact of the elimination of the "reasonable grounds" standard. The proposed changes would affect only the responsibilities of investment managers, and not impose any responsibility on the brokers providing the research to provide information concerning pricing. The lack of transparency on the part of brokers would make the costs to investment managers of complying with the proposed changes even more substantial. Furthermore, the increased compliance burdens under the proposed changes would fall disproportionately on small and medium-sized managers.

We therefore request that the "reasonable grounds" standard remain in the COBS and that the new language establishing a presumption of breach not be added. Further, we urge the FCA to consider requirements mandating that brokers provide investment managers with the information they need to comply with the FCA's rules on the use of dealing commission.

Implications for Managers Doing Business on a Global Basis

Finally, we note that many investment managers operate their businesses and provide their services on a global basis, and the proposed standards would not be consistent with those of other jurisdictions, including the US. For example, the US Securities and Exchange Commission in its 2006 guidance concerning the scope of section 28(e) "soft dollar" safe harbor under the Exchange Act of 1934 stated that (1) meetings with corporate executives to obtain oral reports on the performance of a company are eligible for the safe harbor; and (2) market data, such as stock quotes, last sale prices, and trading volumes, are eligible as "research services" under the safe harbor.[4] In the case of corporate access, the SEC reasoned that "[m]eetings with corporate executives to obtain oral reports on the performance of a company are eligible because reasoning or knowledge will be imparted at the meeting (i.e., reports) about the subject matter of Section 28(e) (i.e., concerning issuers)." Similarly, the SEC supports the treatment of the provision of "raw" market data as research: "In our view, this approach will promote innovation by money managers who use raw data to create their own research analytics, thereby leveling the playing field with those money managers who buy finished research, which incorporates raw data, from others."[5]

The establishment of UK rules that differ from other jurisdictions could disadvantage UK clients, and/or discourage investment managers from offering their services in the UK. For example, many managers place their orders for securities transactions on a "block" basis, which generally benefits their clients, and orders from UK firms may be aggregated with orders from non-UK affiliates in a group that uses a fully integrated trading and research platform. This practice aims to achieve economies of scale and to treat orders from different clients equitably. If the commissions related to these orders *may* be used for services that *might* not qualify for the exemptions set forth in the COBS, for example, because information on the cost breakdown is not available from a non-UK broker (and the manager cannot rely on a good faith or reasonable analysis, under the changes proposed in the Consultation Paper), managers may feel compelled to separate out UK clients from these otherwise advantageous arrangements.[6] If UK rules are not harmonized with those in other jurisdictions, the result could disadvantage UK clients, and present practical, logistical, and client relations issues.

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[4] *See* U.S. Securities & Exchange Commission, Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Rel. No. 34-54165 (July 18, 2006).

[5] The SEC also noted that "excluding market data from the safe harbor could become meaningless if it encouraged purveyors of this information to simply add some minimal or inconsequential functionality to the data to bring it within the safe harbor." Id.

[6] We note that the limitations on aggregating account trades under COBS 11.3.7R generally allow aggregation only where such aggregation would benefit the client; therefore, not allowing otherwise advantageous aggregation would operate to disadvantage UK clients.

In the alternative, investment managers may opt not take on UK clients, if the managers determine that they cannot provide the same benefits to UK clients as they can provide to their other clients. Either result could ultimately disadvantage UK clients. Under certain circumstances, managers may not be able to effectively "ring fence" the arrangements for UK clients without potentially negative consequences. Therefore, we urge the FCA to reassess and revise the proposed changes, and allow investment managers the opportunity to provide further comments on such revisions before any changes are finalized. As part of its reconsideration, we support increased FCA collaboration with other international regulators in order to promote harmonization of regulatory requirements for firms that do business on a global basis.

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We appreciate the opportunity to provide our views on these issues and would be pleased to provide any additional information. Please contact the undersigned or Karen L. Barr, General Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully submitted,

Kathy D. Ireland
Kathy D. Ireland
Associate General Counsel