# Dealing commission and best execution: action points for portfolio managers

Once again, the regulatory spotlight is on the use of dealing commission and the best execution obligation, both tenets of the regulatory obligations to act in clients' best interests, treat customers fairly and avoid conflicts of interest; and on the FCA's radar under its new competition objective.

Recent regulatory pronouncements come in the form of the FCA's discussion paper (DP) on the use of dealing commission regime[1] and its thematic review on best execution and payment for order flow[2]. Within these papers, there are (among other things) a number of indicators of good and poor practices. These indicators can be regarded as effective expressions of prevailing regulatory expectations – in other words, a benchmark of which firms are now "on notice" and against which they may be judged. Prudent buy-side institutions will therefore pro-actively assess the extent to which they are in (or out of) line with these indicators; and take any such remedial actions as may be appropriate.

## Background: Use of dealing commission

The FCA "clarified" its regulatory expectations on the use of dealing commission in June 2014, particularly in relation to corporate access and the circumstances where substantive research (which may be paid for from dealing commission) is bundled together with ineligible services (that firms cannot pay for using dealing commission). For a consideration of these changes see our briefing published at the time, **"FCA amends use of dealing commission rules"**.

The FCA was clear in June that it was considering, at a more fundamental level, the use of dealing commission regime as part of its wider supervisory work (in particular, its ongoing review of the wholesale market).

The FCA's wider supervisory work included carrying out a thematic supervisory review on the use of dealing commission between November 2013 and February 2014[3]. The FCA reports on this thematic review in its DP in which it advocates further (and more fundamental) reform of the regulatory regime. The FCA sees brokers' unpriced bundling of research and execution services as "preventing transparent price formation and competition". In particular, the FCA concludes that unbundling research from dealing commission would be the most effective way of addressing opacity of charges and its concerns in relation to inherent potential conflicts of interest when managers use transaction costs to fund external research. The FCA interprets the MiFID II Level 1 text and ESMA's consultation on the Level 2 measures as supporting this view and effectively requiring "unbundling of research from dealing commission arrangements on an EU-wide basis, except for the most generic, widely available commentary" [4].

The FCA is waiting for more detail from Europe before proposing detailed rule changes[5].

In the meantime, there are a number of key messages from the DP that portfolio managers should take on board to ensure that existing practices and systems and controls are adequate to meet current rules and expectations regarding the use of dealing commission.

## Key action points on the use of dealing commission

Portfolio managers are urged to consider and act upon the findings of the thematic review and specifically:

- Make a **mixed-use assessment** where appropriate, to determine which parts of the services it receives are eligible for payment out of dealing commission or not[6].

[1] DP14/3 Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research (July 2014).
[2] TR14/13 Best execution and payment for order flow (July 2014).
[3] The Investment Management Association (IMA) also published an informative report in February 2014 "The Use of Dealing Commission for the Purchase of Investment Research".
[4] In addition, the FCA implies its intention to extend MiFID II unbundling to UCITS and AIFMD investment management activity should the EU fail to make such an alignment.
[5] Which the FCA notes will require significant changes to COBS 11.6.
[6] Firms should have already reviewed their policies and procedures to accommodate mixed-use assessments following the FCA's June 2014 guidance (PS14/7).

- Request that brokers give a clear breakdown of their costs, showing a **specific price for research** rather than being bundled with execution services. The FCA states "We encourage brokers and investment managers to enter into discussions about how much different levels of service should cost". While the FCA recognises difficulties of putting this into practice, managers should make a proper assessment of the value of research services provided by brokers. In particular, managers should put a price on valued research, and challenge brokers on why research not considered of value should be paid for (even if still provided), or on any other aspect that may not fall within eligible research. It is not sufficient to apply an arbitrary, notional split to meet FCA disclosure obligations, a proper consideration of the value of research must be demonstrable. The FCA considers the best approach is to assess value by an independent assessment carried out by people not involved in the investment process, or the use of proxies such as other priced services in the market.
- Consider utilising **independent research providers** that may be able to offer more competitive prices (particularly once unbundling is implemented).
- Allocate a **budget for research** (for example, a total budget for research and individual budgets for different brokers[7]). Setting the budget and payment for research (as opposed to execution costs) should be linked to the value of the research and not the number of trades; adopting a clear methodology will evidence this. Firms should be wary of using a previous year's research commission payment level to set a budget, since it may have been based on trading volumes and not the real value of the research. The FCA suggests that the best approach is to: (i) consider the firm's actual research needs; (ii) make a proper valuation of that research to set a realistic budget; and (iii) ensure payments made from the budget are appropriate. The FCA gives little guidance on how to set a budget. However, as with the valuation of research, budget setting decisions should be seen to be independent and, therefore, common sense dictates that they should not be made by anyone involved in the allocation of trades. In its report on the use of dealing commission, the IMA suggests that setting a budget will be informed by qualitative factors and quantitative data inputs (such as comparisons of a budget as a percentage of value of relevant assets under management, a percentage of total commissions generated, or some measure of value generated for clients). On the other hand, the primary factor considered by the FCA throughout its DP is the real value of the research being provided. While the FCA doesn't address the issue, it seems unlikely that a consideration of other quantitative criteria has a place in the valuation calculation. In addition, where a firm uses both dealing commission and internal resources to fund research, it is important that the firm is able to monitor separately the use of dealing commission.
- Enter **Commission Sharing Agreements** (CSAs) with brokers where possible to properly manage commission payments and switch to execution-only arrangements (so that research payments may cease) once a pre-determined budget is reached[8]. The FCA states that, under its current rules, "it is difficult to see how investment managers can ensure both best execution and appropriate payments for research are made without at least some use of CSAs".
- If commission payments are linked to a **broker vote process**, this process must reflect a proper assessment of the quality of the broker's eligible research only and, again, not be influenced by trading decisions and volumes. In particular, the FCA is concerned about broker voting where the vote does not represent a monetary figure but a percentage of a CSA balance – the broker could provide the same research in two periods and receive the same amount of votes, but be paid a different amount because the trading volume varied.
- Implement **robust oversight** (and consider whether to form a research oversight committee) supported by appropriate management information and reporting lines to monitor the generation and allocation of research spend[9]. In addition, firms should implement checks to ensure that payments made from CSA balances are being made to legitimate service providers for eligible research goods and services.
- Keep **rigorous evidence** of the criteria considered and met when concluding that a service may be paid from commission as it is "eligible research".
- Managers are encouraged to give brokers **feedback** on the quality and usefulness of their research so that brokers may allocate resources effectively and price their research offering appropriately.

The FCA believes that there has been a distinct lack of progress by the industry in relation to the use of dealing commission since it first introduced rules in 2006, even after several supervisory reviews[10]. In publishing the DP, the FCA is explicit in what it considers to be good practice by firms. Investment managers should sit up and take notice as future breaches are likely to be dealt with harshly following the series of warnings from the FSA/FCA.

[7] In its February 2014 report on the use of dealing commission, the IMA considered that the FCA did not require a budget to be set for each broker individually; however, this is certainly indicated as good practice by the FCA in its July 2014 DP.
[8] The IMA makes some suggestions as to how a firm may spread a budget over a relevant period so that the cap is not reached prematurely and to minimise the potential conflict of interest between clients whose transactions are executed before the switch to execution-only and after, for example, shorter budget periods may help to mitigate the effects of uneven trading across clients.
[9] This is recommended by the IMA in its February 2014 report.
[10] During its most recent thematic review, the FCA found that 28 out of the 30 firms it considered did not operate at the level of compliance with existing rules that the FCA expects.

## Background: Best execution and payment for order flow (PFOF)[11]

When executing orders, or placing orders with other entities to execute, an investment manager's primary aim should be obtaining the best result ("best execution") for its client. Where dealing commissions are bundled, it may be difficult for a manager to evidence the achievement of best execution and there is a risk of a conflict between the duty to obtain best execution and, for example, a manager maintaining a relationship with a particular broker with whom the provision of research is linked to the volume of trades.

In addition, the FCA prescribes in its Handbook a number of factors which firms should take into consideration (in conjunction with their relative importance based on the characteristics of their client, the order and the market) in order to achieve best execution: price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of an order[12].

As part of its wholesale conduct strategy, the FCA carried out a thematic review on best execution and payment for order flow. In its report, the FCA sets out the findings and conclusions from its thematic work following a review of 36 firms. Once again, the FCA expresses its disappointment that it has published a number of papers addressing best execution and yet its review found that many firms do not understand their best execution obligations and are not embedding them into their business practices:

> *"Firms need to improve their understanding of the scope of their best execution obligations, the capability of their monitoring and the degree of management engagement in execution strategy, if they are to meet our current requirements."*

While the review did not focus on buy-side institutions, there are many lessons to be learned that apply to all firms that must act in the best interests of their clients. These are highlighted below.

## Key action points on best execution

The FCA stresses that its rules have a broad application and cannot be excluded or waived. It states that firms should urgently review their best execution arrangements and policies and highlights the following good practices:

- Conduct a substantive **review of best execution arrangements and policies** annually and on a "material change"[13], to ensure that they are capable of delivering best execution on a consistent basis. Reviews must take account of the results of monitoring and any changes in the market.
- **Senior management** with responsibility for the dealing desk must take greater responsibility for ensuring that policies and arrangements remain fit for purpose. This includes ensuring that written policies are fully understood, implemented and embedded in business practices and supporting controls.
- While there should be clear ownership of the execution policy with senior manager responsibility, the review process should be complimented by the **involvement of front-office staff** to encourage a common goal and aid delivery of improvements to execution performance.
- **Order execution policies** should reflect the diversity of arrangements for all relevant asset classes. In addition, they must be detailed (including information on how the firm weighs each factor in practice) and readily available. Even where a firm cannot guarantee the best price available to its clients, it should explain the steps taken to price its instruments and demonstrate how best execution is being applied.
- **Disclosures to clients** of the order execution policy should not regurgitate the rulebook but instead, clearly explain the order routing system and ranking of execution factors and take into account the information needs of a client (for example, by using a Q&A format).
- **Differentiate between different categories of clients** when executing orders. In particular, a different standard of execution applies to retail clients as compared to professional clients.
- It is good practice to clarify that a firm will always use its judgement to obtain the best possible result for a client within the constraints of the **client instructions** (that is, that it will apply best execution), rather than seek to rely on the protection of client instructions. A blanket exclusion of best execution obligations where an order contains an element of client instruction is not permitted.
- When a firm monitors with the use of **pre-determined benchmarks** as triggers, it must be able to explain the methodology and tolerance setting for a particular benchmark and keep its use under regular review. The FCA is clear that the main market touch price (or "yellow strip") is not an appropriate benchmark to use.
- Carry out regular monitoring of **choice of execution venue and counterparties** to assess their ongoing suitability. For example, an appropriate monitoring system for venues could include considerations of liquidity, toxicity[14] and reversion analysis[15].

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[11] PFOF is the practice of an investment firm which executes client orders (the broker) receiving commission both from the client originating the order and also from the counterparty with whom the trade is then executed (the market maker).

[12] Best execution is considered in detail in the FCA Handbook, COBS 11.2.

[13] The FCA indicates that a "material change" includes, for example, the merger of two execution venues or a change in the identity of a Direct Market Access (DMA) provider.

[14] That is, considering the characteristics of the order flow attracted by different venues to assess whether this flow poses a risk to the clients' best interests.

[15] Reversion analysis measures the implicit costs of order executions and the extent to which the market impact of a firm's order flow moved the price on venues to which orders are routed.

- When **delegating**, firms must know the identity of relevant third parties, which entity is responsible for best execution, and effectively monitor the performance of the third party in relation to best execution.
- In order to overcome potential conflicts of interest, there should be **effective oversight** of compliance with best execution and its monitoring which is adequately resourced and will assess whether best execution is in fact being achieved rather than whether the firm's own policies are being followed (as they may not amount to the same thing). The effectiveness of the monitoring programme should be regularly reviewed (at least annually at the same time as the annual review of execution arrangements and policies).
- Ensure that the best execution obligation applies equally to **connected parties** as it does to other third parties.

The FCA is keen that firms are fully compliant with existing best execution rules in readiness for further reform on the implementation of MiFID II. While it will depend on the context, the FCA's report arguably implies that records of monitoring and a problem being escalated and rectified is likely to indicate to the FCA the existence of an effective monitoring programme contrasted with ineffective or non-existent monitoring. The FCA likes to see a system that works:

> *"… regardless of how monitoring is delivered (and by whom within a firm) it is only of use in assessing whether best execution is being delivered to clients if it covers the whole scope of a firm's activities, has sufficient depth to account for the scale of those activities and does so in a way which supports the delivery of best execution by detecting issues and facilitating corrective action."*

In addition, it is imperative that firms are able to evidence to the FCA ongoing monitoring and reviews (and implementation) of internal policies and procedures. The FCA found during its review of best execution that a number of firms have not regularly re-visited their policies, in some cases since 2007 when MiFID was implemented – clearly unacceptable in light of the above guidance.

## Conclusion

In these further clarifications and discussions, the FCA continues to pursue keenly its ultimate goals of consumer protection and promoting effective competition. It also gives a clear message that it wants to lead the thinking for the development in this area under MiFID II.

At the local level, firms must be alert to the indications of good and poor practices that the FCA highlights in its papers in relation to both the use of dealing commission and best execution. While this guidance from the FCA may not be found in the FCA Handbook, in has become common place for the FCA to rely on such alternative proclamations as evidence of it communicating acceptable and unacceptable conduct to firms. Since the FCA has published a number of papers on both topics over recent years, it is becoming impatient. Ignorance by firms of the FCA's views of acceptable conduct will not be an acceptable excuse where the FCA finds non-compliance.

Firms have now been warned …

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