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FCA issues press releases on best execution and dealing commission

Attorneys
Monica Gogna
Michelle Moran

The FCA issued two important press releases on 3 March 2017, outlining its findings from its recent supervisory work on firms' use of dealing commission and firms ensuring effective oversight of best execution.

Dealing commission

The FCA has published a number of papers on dealing commission since 2012, most recently a policy statement in 2014, in which the FCA particularly restricted firms from using dealing commission to pay brokers for "corporate access" (meetings between an investment manager and senior staff of an issuer).

The FCA's press release is a summary of its findings following visits to 17 firms to assess their dealing commission arrangements.

The FCA raised the following concerns:

- In relation to research budgets, the FCA noted that some firms showed "little thought or consideration" on how research budgets are set and managed and that budgets are frequently linked to prior years' research spending levels (which are a factor of past trading volumes). The FCA noted that firms without any form of budgeting have research spending levels closely correlated to trading volumes. The FCA also identified several instances where firms with budgets did not limit research expenditure to the budget, with no satisfactory explanation as to why.
- The FCA noted that arrangements to demonstrate that only "substantive" research is paid for using dealing commission were "generally poor or missing".
- The FCA noted that the majority of firms continued to treat the receipt of corporate access from brokers as a free provision.
- The FCA stated that firms with overseas operations and those that delegated investment management services often failed to implement controls to ensure that outsourced activities complied with the rules – confirming that the FCA does require delegated mandates to be subject to its rules.

Positively, the FCA noted that some firms in its sampling cover the cost of externally produced research from their own resources rather than using dealing commission, and that other firms have adopted processes that demonstrate consideration and control on spending dealing commission, reducing overall expenditure on research. The FCA also noted that some firms have implemented research budgets based on factors such as an estimate of the cost of producing research internally or acquiring it from an external provider.

As a general observation, the FCA stated that, despite some progress being made, much of the poor practice it had previously highlighted is still commonplace.

MiFID II will take effect in January 2018. UK firms are now almost universally making changes to the way they purchase research from brokers to meet MiFID II's requirements for full unbundling or direct payment. Notwithstanding the work that firms are doing to meet MiFID II, the FCA stated in its release that "where we identify breaches of our rules or principles, we will consider appropriate action, including more detailed investigations into specific firms, individuals or practices."

Best execution

The FCA has conducted various thematic reviews to improve firms' approach to best execution. The following are the highlights of its findings:

- As a general point, the FCA stated that much of the poor practice outlined in its prior thematic review has not been addressed.
- In terms of good practice, the FCA pointed to:
    - where best execution was considered throughout the investment decision-making process, and not just the dealing desk;
    - improvements on the equity side where firms had decreased the cost of trading by using low-cost trading venues such as broker-supplied algorithms, direct market access and broker-crossing networks;
    - good governance processes within firms that challenged the overall costs of execution and re-negotiated commissions.
- The FCA had the following less positive findings:
    - Whilst all firms had management information that allowed them to accurately view equity execution costs, use of this data was inconsistent. Some firms could not evidence any improvement to their execution process based on these data and the review of it was largely a "tick box" exercise.
    - The FCA found instances where compliance staff were not empowered by senior management to provide effective challenge to the front office on execution quality. Sometimes they lacked access to the data used by the dealing team or they did not use data already available, such as gifts and entertainment logs. This led to a "tick box" monitoring process where failings were unlikely to be discovered.

In terms of next steps, the FCA stated that it will revisit best execution in 2017 to see what steps investment management firms have taken to assess gaps in their approach to achieving best execution and how they can evidence that funds and client portfolios are not paying too much for execution.

The FCA did not indicate that it will take enforcement action prior to revisiting the topic later this year, allowing firms to improve their processes as part of their MiFID II implementation.

Links to the press releases are below:

- Dealing commission
- Best execution

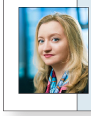
London Office
Asset Management Contacts

60 Ludgate Hill | London EC4M 7AW | +44 20 3201 1500
email: firstname.surname@ropesgray.com

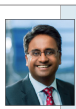
If you have any questions on this Alert, then please contact your usual Ropes & Gray contact or reach out to our UK Asset Management team.

ASSET MANAGEMENT PARTNERS AND COUNSEL

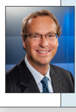
Monica Gogna
Partner
+44 20 3201 1630



Michelle Moran
Partner
+44 20 3201 1638



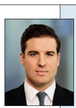
Anand Damodaran
Partner
+44 20 3201 1627



Mathew Judd
Partner
+44 20 3201 1633

Anna Lawry
Counsel
+44 20 3201 1590

ASSET MANAGEMENT ASSOCIATES



James Board
Associate
+44 20 3201 1609

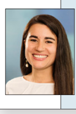
Gabriel Cooper-Winnick
Associate
+44 20 3201 1520

Joshua Cronin
Associate
+44 20 3201 1521

John Young
Counsel PSL
+44 20 3201 1589

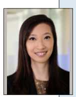
Deirdre Haugh
Associate
+44 20 3201 1535

Kirsten Lapham
Associate
+44 20 3847 9032



Lorenza Prelz Oltramonti
Associate
+44 20 3201 1694

Andrea Renold
Associate
+44 20 3201 1570



Rae Hui Shee
Associate
+44 20 3201 1576

David Walters
Associate
+44 20 3201 1581