Securing the future of pensions

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Dear Adam,

NAPF response to CP13/17 – consultation on the use of dealing commission rules

The NAPF is the leading voice of workplace pensions in the UK. We speak for 1,300 pension schemes with some 16 million members and assets of around £900 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

The NAPF is grateful for the opportunity to respond to the FCA's consultation on the use of dealing commission rules.

The effective use of good quality research is clearly of benefit to our pension fund members – the clients of investment managers – as they should benefit from the improved performance emanating from the use of this research in what is a highly competitive market. Furthermore, it is self-evidently in the interests of pension fund clients of investment managers that there is a competitive research market providing coverage of small and large cap stocks in local and global markets.

The FSA's thematic review and subsequent debate within the industry has demonstrated however, that there are misunderstandings (and in some cases flagrant abuse) of the current rules. We are therefore supportive of the proposed tightening of the Conduct of Business rules in relation to the use of dealing commissions to purchase research; in particular:

- We agree that paying for corporate access from dealing commissions should not be permitted.
- The introduction of a presumption of a breach of the rules if the cumulative criteria are not met and further clarifying the research criteria to reflect the original intention of the rules is positive.
- The provision of further guidance which reminds investment managers of their duties to act in the best interests of their customers is always welcomed.

Whilst the proposed changes to the rules on the use of dealing commission for purchasing research are positive, we do not believe that they will be sufficient of themselves to ensure that the interests of clients are adequately protected and served. Limiting the range of uses of dealing commissions is a helpful first step; however, the NAPF encourages the FCA to press ahead with its wider review.

The NAPF is of the view that the current model for paying for research leads to the creation of too many conflicts of interests, an over-use of and over-supply of external research – not all of which is necessarily value-added – and a significant lack of transparency to clients. As such, in the short term we believe there should be:

- Much improved disclosures from investment managers to clients of their policies and processes for utilising dealing commissions and for managing the arising conflicts of interest.

- Enhanced disclosures to clients allowing quick and simple identification of the full range of costs borne by their investments and enabling easy assessment of the net return to them.

- A requirement that investment managers should give a positive attestation that they have valued research carefully, only purchased that which is necessary; thus managing the cost as carefully as they would any other cost to the firm itself. This attestation should be subject to independent assurance.

In the short to medium term, we encourage the FCA to give further consideration to:

- At a minimum, a move to full unbundling with explicit ex-ante pricing by research providers, including brokers, for research services offered.

- The potential prohibition on the use of dealing commissions to purchase research – ideally at an international level - considering how the industry can move towards a cash model for research, accepting that research is a cost of doing business for investment managers. How the cost of external research is passed onto clients should be clearly understood and agreed to in the contractual agreement between the two parties.

The NAPF looks forward to working with the FCA and others in the industry in considering how to move forward.

Yours sincerely

Paul Lee
Head of Investment Affairs
NAPF

Consultation questions

1. **Do you agree with detail of the rule and guidance changes we have proposed?**

2. **Do you agree with the justification and cost benefit analysis for these changes?**

3. **Do you believe there are likely to be any material, incremental costs or benefits which we have not considered here?**

We respond to the three consultation questions together.

The commissions used by investment managers to pay for soft or bundled research are the property of their clients. As such to meet their responsibilities to their clients, investment managers must use the soft commissions generated by trading only for research services that benefit their clients.

The NAPF considered that the evidential test for research within the current COBS was clear. As such we were disappointed to note the results in 2012 of the published findings from FSA's thematic supervisory work on *Conflicts of interest between asset managers and their customers*. It was clear from this that:

- Some investment managers were failing to adequately control their use of dealing commission.

- Misunderstandings of what constituted research had been allowed to develop within the industry.

- There was insufficient enforcement of the current rules, whether through the regulator or via accountability to clients.

In light of these identified failings, the NAPF is supportive of the proposed reforms to the current rules on the use of dealing commission.

<u>Corporate access</u>

We agree that paying for corporate access from dealing commissions should not be permitted. Indeed, we note that it is difficult to see how this practice could be seen to meet the current evidential tests of:

- Adding value by providing new insights

- Representing original thought

- Having intellectual rigour

- Involve analysis or manipulation of data to reach meaningful conclusions.

The NAPF is a public supporter of the UK Stewardship Code and is clear in its belief that effective engagement with investee companies is an important element of good stewardship. However, we do not believe that payment for access to company management via dealing commission is appropriate. As the FCA rightly identifies, using dealing commission to purchase corporate access lacks transparency to the client. It can create a perverse incentive for investment managers to direct trades towards brokers who provide access to companies rather than maintaining the best execution as the basis for their decision.

More pertinently, companies themselves should be picking up the mantle and taking responsibility for engagement with their current and prospective shareholders as a normal part of their investor relations operations. If the company's house broker assists them with the organising of meetings with investors, then the company should be primarily responsible for paying for this, either on an ad hoc basis – e.g. for a one-off roadshow or through a retainer. The company should, in any case, be attempting to treat all investors equally.

Reaffirming the narrow definition

The NAPF is supportive of the proposal to introduce a presumption of a breach of the rules if the cumulative criteria are not met. In addition we welcome the proposal to require 'meaningful conclusions based on analysis or manipulation of data'.

We believe that these changes should reaffirm that 'research' in the context of paid for research from dealing commission does not include the mere republication of results announcements or data from which the in-house research team may conduct actual research. There is a sense that at present there is an over-supply of non-value adding external research. To the extent that the investment management industry relies on such 'research' it fails to demonstrate that it is not just a substitute for costs that should be borne by the fund manager itself simply as a cost of doing business.

We would however, encourage some caution. We would not wish for the resultant rules to be unintentionally perceived by some as so prescriptive as to restrict the use dealing commission to research which directly leads to a buy/sell decision. The current model of use of dealing commission already has the potential to perversely incentivise the trading of shares, thus undermining buy and hold and stewardship approaches. It is important not to create a model which could potentially undermine endeavours to be a good stewardship investor by unintentionally restricting access to research that does not relate to a buy/sell decision but may instead result in a 'hold' decision. Such research does often provide significant value-added insight into the governance arrangements or strategy of an investee company.

Wider review

Whilst we believe that the proposed clarifications and additional guidance are welcome, we encourage the FCA to press ahead with its wider review of this issue.

The issue of costs is rapidly up the pension scheme agenda. While there are various elements of the overall costs faced by schemes, and the focus initially has been on the most transparent and largest, attention is shifting to those that are less clearly disclosed.

At present, the level of disclosure about commission spend to pension fund clients mean that it is difficult to understand how their money is being spent and how that spending is in their interests. The NAPF therefore would like to see greater transparency and accountability in this area. This we believe would have profound implications for the way commission is allocated and the value generated from this spending.

Given this the NAPF believes that there should be:

- Much improved disclosures from investment managers to clients of their policies and processes for utilising dealing commissions and for managing the conflicts of interest that arise.

- Enhanced disclosures to clients allowing quick and simple identification of the full range of costs borne by their investments and enabling easy assessment of the value generated through this expenditure.

- A requirement that investment managers should give a positive attestation that they have valued research carefully, only purchased that which is necessary thus managing the cost as carefully as they would any other cost to the firm itself. This attestation should be subject to independent assurance.

We would be pleased to work with the rest of the industry to develop best practice models to deliver these aims.

However, whilst it is important to fulfil the principle that clients should be more aware of how their money is being spent by their agents to enhance and protect the value of their fund, the conflicts of interest that the current model creates mean that it is time again to undertake a more fundamental review. If one was to create a system from scratch, it is unlikely that one would design the current model.

The IMA and others have communicated well the conflicts and other issues that arise within the current model. Some of the issues are summarised below:

- Commission is generated irrespective of whether that trade has been made on the basis of the research service purchased;

- The size of the research commission is generally calculated as a percentage of a bundled rate and not as a monetary value. This means there is an illogical correlation between the size of the trade and the size of the research commission.

- There is a further illogical correlation between the level of trading and the generation of research commission. Whilst trading levels may very well be volatile, the research needs of the investment manager should not be equally volatile.

- Given the accumulation of dealing commission there is a risk of over-consumption of un-needed research.

- There is a linked concern that there is an over-supply of research of low or no value.

- Payment for research through dealing commission obscures pension funds' ability to distinguish between investment managers based on their ability to generate value from research.

- There is an artificial bias for investment managers to have services provided by brokers, distorting competition.

In light of the above, the NAPF is of the view that in the relatively short to medium term the FCA should give further consideration to:

- At a minimum, a move to full unbundling with explicit ex-ante pricing by research providers, including brokers, for research services offered.

- The potential prohibition on the use of dealing commissions to purchase research – ideally at an international level - considering how the industry can move towards a cash model for research, accepting that research is a cost of doing business for investment managers. How the cost of external research is passed onto clients should be clearly understood and agreed to in the contractual agreement between the two parties.

The NAPF is of the view that it should be possible for the industry, primarily the sell-side brokers, to devise a system of price discovery for the provision of research services. A truer, well-functioning market based upon explicit pricing would permit informed decisions to be made about the relative value of each type of provider – brokers and independent providers - and of the investment manager's own research capability and ability to extract value added from the research.

A priced market would likely be easier to navigate. The move to the use of CSAs has, to some extent, meant a de facto move towards a priced system, with investment firms allocating commission to pay for specific research from third parties but further steps are needed. External research pricing would allow better comparison with the cost and value of internal research teams and may diminish the over-supply and over-consumption of research.

Ultimately, we agree with the argument that the use of research is essentially a cost of business for investment managers. As such, the principle that the investment manager should incorporate research costs within their own overheads rather than this cost being borne by commissions out of clients' portfolios is a strong one. Essentially, if a firm is offering a product – an active equity fund – then a customer considering purchasing that product should be able to expect that the firm offering the product has the services and capabilities it needs to deliver upon the offering it is making.

It has been suggested that if research costs were charged to an investment firm's cost of business rather than deducted from clients' portfolio performance, investment managers would perhaps be much more discerning about what research they purchased and how much they were prepared to pay for it.

While being mindful of the potential impacts on competiveness, especially in terms of preventing barriers to entry for new smaller entrants, the NAPF is supportive of a debate about the introduction of a prohibition on the use of dealing commissions to purchase research – ideally at an international level. Considering how the industry can move towards a cash model for research, accepting that research is a cost of doing business for investment managers would remove many of the conflicts present within the current system.

How the cost of any purchased external research was passed onto clients should be clearly understood and agreed to in the contractual agreement between the two parties.

The NAPF is very happy to work with the FCA and others in the industry in considering how to move forward with any of the aspects discussed above.