NAPF
Securing the future of pensions

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Dear Laurent,

MiFID II/MIFIR Consultation Paper – dealing commission payments for investment research

The NAPF is the voice of workplace pensions in the UK. We speak for over 1,300 pension schemes that provide pensions for over 17 million people and have more than £900 billion of assets. We also have 400 members from businesses supporting the pensions sector.

We aim to help everyone get more out of their retirement savings. To do this we promote policies that add value for savers, challenge regulation where it adds more cost than benefit and spread best practice among our members.

Our members, as significant institutional investors and customers of the asset management industry, welcome many of the objectives which are being implemented through MiFID II. It is in this latter context that we wish to convey to you the views of pension fund clients with respect to the restrictions proposed to be placed on fund managers in relation to the use of dealing commission for the purchase of investment research.

Overview

NAPF members have around €150 billion invested in in equities across the EU as well as significant investments in government and corporate bonds across Europe. As such 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 that there is a competitive research market providing coverage of small and large cap stocks in local and international markets. Efficient markets lower the cost of capital and assist the free movement of capital to where it can be best used, helping drive economic growth.

Our members however, consider that the current use of commission to purchase investment research creates an inherent conflict of interest for investment managers. The use of client money to purchase research displaces what would otherwise be a cost of business for the fund management firm and results in an over-use of and over-supply of external research which is purchased without the level of rigorous due diligence and oversight that a firm would apply to spending its own money. Few other industries have the luxury of using their clients' money to buy a key raw material in their industrial process making their offering appear cheaper

than it is in practice. To the extent that the investment management industry relies on external research it fails to demonstrate that it is not just a substitute for costs that should be borne by the fund manager itself as a cost of doing business.

We commend the work undertaken in the UK by the Financial Conduct Authority (FCA) on this issue and in particular the results of their recent thematic review and resultant conclusions which are set out in their July 2014 discussion paper. In particular we echo their conclusion that the use of dealing commission to fund external research will continue to give rise to conduct risks even with close regulatory scrutiny, due to the inherent conflict of interest it creates for investment managers by allowing research to be paid for with transaction costs borne by their customers' funds.

Our members are therefore supportive of the intention to reform this market and to bring much greater transparency to clients for the use of their money. At the same time, we do have concerns that the current proposals, while well intentioned, risk creating further uncertainty and in turn potential regulatory arbitrage. Our members would favour a cleaner and more complete unbundling of all research from dealing commission. We note ESMA's general conclusion that transparency alone is not a satisfactory answer to the issue of conflicts of interest.

If the current carve-out within MiFID II is to be maintained, then we do believe that the intended definition of minor non-monetary benefits as articulated within the consultation paper should be more closely reflected within the draft technical advice. The current wording appears fairly ambiguous and open to increasingly widening interpretation.

We have set out below further comments in response to the questions that were included within your consultation paper.

Question 79 Do you agree with the proposed exhaustive list of minor non-monetary benefits that are acceptable? Should any other benefits be included on the list? If so, please explain.

Whilst the objective to limit the use of commission to the purchasing of only minor non-monetary benefits is positive, we do not believe it will be sufficient to ensure that the interests of clients are adequately protected and served.

If a carve-out is to remain as currently proposed, then the NAPF does not favour efforts to draw up an exhaustive list of non-monetary benefits that can be considered to be minor and therefore acceptable.

It could be acceptable for other non-monetary benefits which are unlikely to influence the behaviour of the recipient to be included within this carve-out, as such clear and strict criteria for the acceptability of any other non-monetary benefits will give greater clarity as to the intentions against which NCAs can reference. It may also be appropriate explicitly to make reference to particular products or services that are not deemed to be acceptable non-monetary benefits such as corporate access.

Other "acceptable" non-monetary benefits could for example include attendance at relevant conferences; information or documentation relating to markets, macro-economic factors or political considerations; similarly information or documentation relating to indices would appear to be acceptable. We suggest that a more helpful approach would be for the draft advice to state that, as described elsewhere within the consultation paper, a service should only be deemed a minor non-monetary benefit if:

- It is accessible to at least a large proportion of market participants, and
- simultaneously widely distributed, and
- not specific to a particular portfolio or client, and
- does not involve a third party allocating valuable resources to a specific client.

An example of the current mismatch between what is set out within the consultation paper and what is conveyed within the advice is that it is explained in paragraph 13 that only mass-distributed products could be deemed "acceptable". However the proposed advice at para 5.i states: "This information could be generic in nature *or "personalised to reflect the circumstances of an individual client*". This seems to be at odds with the proposition in the earlier text and we believe that it should be deleted.

It should be emphasised that the NAPF does believe that effective use of research can be a significant driver of investment returns to clients. Our members fully expect that in an environment where the use of dealing commission is more restricted Investment managers would still need to access a flow of investment ideas and should therefore be prepared to pay for value-added external research. This external research would no doubt continue to include to varying degrees: bespoke reports and analysis, research on particular instruments or companies, market or sector wide analysis; attendance at roadshows and meetings as well as more generic commentary. It seems perfectly reasonable to expect that payments for these products and services could be operated on a mixture of fixed fees and subscriptions. But these payments should come from the fund managers, not from client assets.

A truer, well-functioning research market based upon explicit pricing would permit informed decisions to be made about the relative value of each type of product and provider and of the investment manager's own research capability and ability to extract value added from the research. 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.

A final practical but important point relates to the acknowledgment that these proposals being taken forward through MiFID give rise to an unequal regulatory position between AIF managers and UCITS managers. Accordingly, we would request that attention is given to ensuring that any new requirements are introduced on a level playing field in order to avoid fund management groups simply restructuring internal arrangements to circumvent the spirit of the new restrictions.

Question 80 Do you agree with the proposed approach for the disclosure of monetary and non-monetary benefits, in relation to investment services other than portfolio management and advice on an independent basis?

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 to institutional clients such as pension funds about commission spend means that it is difficult for them to understand how their money is being spent and how that spending is in their interests. The NAPF therefore supports efforts to bring greater transparency and accountability to this area.

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.

However, while we believe that improved disclosures are necessary and important, we do not believe that better disclosure of dealing commission charges will in and of themselves provide sufficient scrutiny on investment managers to ensure they apply a similar degree of rigour in spending dealing commission as a firm would apply to spending its own money. We note ESMA's general view that transparency alone does not resolve conflicts of interest issues.

Question 82 Do you anticipate any additional costs in order to comply with the requirements proposed in this chapter? If yes, please provide details.

It is commonly argued that if reforms were introduced which in effect required unbundling then this would simply move the cost for external research from dealing commission charges into the Annual Management Charge (AMC) and as such there would be no net benefit to customers. The NAPF is however, sceptical of this.

Anecdotal feedback from our members which have 'unbundled' commission spending suggests that there are significant annual cost savings to be made. Indeed, if greater due care was given then it would be fair to assume that more value could be gained for less spend. The FCA's conclusion is clear: fund managers are not as careful in spending client assets on commission as they would be if spending their own money. In an unbundled world, if costs are poorly managed, the most immediate impact would be on the investment manager's bottom line and not on their customers' funds.

It appears a reasonable supposition that detaching research payments from execution arrangements would cause investment managers either to bear the costs directly, to find efficiencies in their research consumption, or reflect these costs in more visible headline charges (such as the annual management charge). This is likely to result in investment managers applying much more scrutiny to research spending, and seeking to maximise value for money to justify the value-added benefit obtained for their customers.

Our members are of course not naïve to the significant impact that a move away from purchasing investment research via commissions could have on the research market. There could likely be an impact upon:

- The competitiveness of European firms with vis a vis the US and Asia;

- The level of competition within both the investment management and research market;

- The breadth of coverage of stocks, especially with respect to SMEs;

- An increased cost of external research provision for smaller firms which are currently cross-subsidised;

Our view is that while these concerns are genuine their likely impact is difficult, if not impossible, to properly assess. Recent trends already indicate that the market is responding to the attention being directed on the issue by the FCA in the UK with new and innovative providers entering the market. In general our members are

of the view that the most significant impacts would likely be short-term and the market would in relatively short-order adjust. The resultant market would in turn be more competitive, include more provision from independent providers and act more transparently in the interests of the end clients for whom the system should be operating. In order to ensure that this market transformation is as smooth as possible it will be important to ensure that the lead in time is appropriate.

Yours sincerely

Paul Lee,
Head of Investment Affairs
NAPF