CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

Independent Research: because they're worth it?

By Vince Heaney
Published by the CSFI
Monday,19 November 2012

Note on the corporate access angle, raised in last year's CSFI report and followed up by FSA in its review of conflicts of interest in asset management. The new CSFI report covers the outcome of this review.

One aspect of the CSFI report *Independent Research: because they're worth it?* that might be worth a follow up is corporate access: the practice of investment banks organising meetings between companies and asset managers. Payment for it has been taken out of the "research and execution" budget, when it is clearly neither. This disadvantages independent research providers, who are fighting for a level playing field with the sell-side analysts.

On Friday, November 9, the FSA published a "Dear CEO letter": *Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks*

http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf

Point 3 in the new FSA document is key – see bold type:

> "**3 How firms managed the purchase of research and trade execution services on behalf of customers**
>
> 3.1 Too few firms adequately controlled spending on research and execution services
> Firms regularly spend millions of pounds of their customers' money buying research and execution services from brokers. Only a few firms we visited exercised the same standards of control over these payments that they exercised over payments made from the firms' own resources. One firm had carefully considered which services represented valuable inputs to its investment process and challenged brokers about why it should pay for other services. Another firm set a maximum spend on research services and, once these limits were reached, switched commission rates for the brokers concerned to execution-only rates for the remainder of the commission period. These firms could show us that they were both acting in their customers' best interests and putting customers' interests before their own.
>
> **Poor practice we identified included no central organisation of commission payments where individual fund managers paid for research services by directing business to particular brokers on a trade-by-trade basis. It was unclear to us how firms using this approach monitored whether they were acting in customers' best interests.**
>
> **3.2 Firms did not regularly review whether services were eligible to be paid for using customers' commission**
>
> COBS11.6.3R limits what can be purchased to 'execution' or 'research' services. COBS11.6.5E provides evidential standards to determine what constitutes research. We found that few governing bodies regularly reviewed whether the products and services purchased using client commissions were eligible to be paid for with customers' funds. **In particular, various firms were**

using commissions to pay for market data services and were unable to demonstrate how these met all of our evidential standards for research services. Firms were also unable to demonstrate how brokers arranging for access to company management (see point 1 below) or providing preferential access to IPOs, constituted research or execution services.

…

1 Access to company management (sometimes also referred to as 'corporate access') means, in this context, the practice of third parties (typically investment banks) arranging for asset managers to meet with the senior management of corporations in which the asset manager invests, or might subsequently invest, on behalf of customers. It does not refer to any research services that might be provided by the third party alongside providing access to company management."

The following box is taken from Independent Research: because they're worth it?
By Vince Heaney
Published 19, November 2012 by the CSFI
Commissioned by Euro IRP:

FSA takes action on corporate access.

The UK fund management industry is expected to stop paying for corporate access services with dealing commissions after the Financial Services Authority in November 2012 published a letter outlining its opinions on the issue. This represents a significant levelling of the playing field for IRPs, which typically are not in a position to provide fund managers with access to senior company management in the same way as sell-side side brokers and investment banks.

Corporate access was brought on to the regulator's radar following the publication of last year's CSFI/EuroIRP report *"Has independent research come of age?"* The report concluded that "use of dealing commissions to pay for corporate access services provided by investment banks is… evidence of continuing market distortions that legislation in the wake of the Myners report sought to eradicate".

National press coverage of the report picked up on the call for corporate access to be scrapped from the list of activities that dealing commissions are able to cover. Following the call for the FSA to take action, Peter Allen, chairman of EuroIRP, and myself, as author of the report, met the FSA to discuss the issue of corporate access. It was clear from these meetings that the FSA intended to investigate the issue with market participants.
…
The FSA said that all the buy-side firms it spoke to believed corporate access was a valuable service and they paid for it with dealing commissions. The FSA has, however, concluded that the buy-side firms were unable to demonstrate that their use of dealing commissions for corporate access satisfied its evidential provisions.

……

<u>In addition, please note</u>:
According to the Thomson Reuters Extel Survey 2012, the proportion of dealing commissions used to pay for corporate access increased to 29 per cent in 2012, compared with 27 per cent in 2011 and 21 per cent in 2010. Also, corporate access is now the largest component of services provided by the sell-side, overtaking trading and execution (28 per cent) and research (26 per cent) for the first time.