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Wholesale Conduct Policy & Client Assets
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Dear Sirs,

Consultation Paper CP13/17
Consultation on the use of dealing commission rules
Comments – The European Association of Independent Research Providers (Euro IRP)

I am writing on behalf of Euro IRP, the trade association which represents Europe's independent research providers, in response to CP13/17, your consultation on the use of dealing commission rules.

Framing this response is complicated by the fact that the members of Euro IRP are not a homogenous grouping. Our members are paid in a variety of ways by their clients – hard dollar payments, voted CSAs, commission funded subscriptions and a mixture of all three. In addition our members offer a wide variety of different products, from consultancy based macro/investment strategy offerings to detailed sector focused stock level research. As a consequence the impact of the proposed rule changes will affect our members in a range of different ways.

However, there is a key similarity across our membership and that is an explicit avoidance of conflicts of interest with our buy-side clients. The majority of our members do not offer execution services. Even those that do are required to affirm that they will not carry out proprietary trading. In addition members are required to attest that they do not derive their revenue primarily from investment banking, underwriting or corporate broking, market making, management consultancy services for clients other than investors, or from companies that were the subject of this research.

This absence of potential conflicts of interest is, we believe, highly valued by our buy-side clients. So is the quality of the research offered by firms which pride themselves on the expertise and understanding underpinned by years of experience and, critically, by business models that eschew cross-subsidisation. Unlike the investment banks and brokers our members must offer high value research, as they don't have any other revenue streams to fall back upon. Unfortunately the traditional research market in the UK has been dominated by Ibs and brokers who have traditionally been paid for a much wider range of services, including corporate access and primary market allocations, using clients 'commissions'.

It is for this reason that Euro IRP broadly welcomes the proposed rule changes embedded in CP13/17 and looks forward to ongoing scrutiny of the research market. We would encourage the FCA to seek to ensure transparency of payment mechanisms, clearer pricing of research services and a more comprehensive and balanced approach to the valuation of such services, whether provided by banks/brokers or by independent research providers. Further, it is important in seeking to ensure such transparency, that this is done in conjunction with creating transparency across the whole range of products and services paid for by fund managers. In the absence of broader industry transparency, those firms with multi-product offerings (Ibs and brokers) will remain at a considerable advantage to those with a single product offering. A level playing field allowing competition in the provision of research will only be achieved with the elimination of cross-subsidisation within multi-product firms. The FCA should also be careful to ensure that the market for credit research is treated appropriately, given that bonds trade on a bid/offer spread basis rather than via commissions. (The market for credit research is substantially different from that for equity research and separate responses from our credit research members will be forthcoming.) To look at the specific proposed rule changes in order.

First, the clarification of the definition of research and the introduction of a presumption that services are not research when the criteria are not met.

Euro IRP believes that clarity in the definition of research is extremely valuable as long as client commissions are being used as (part of) the payment mechanism. The definition should apply to the services being provided, rather than each piece of research, and we would propose if that provider's research substantially meets the definition, then the service be treated as substantive research.

In the absence of clear definitions there is an ongoing danger that individual voters on the buy-side will seek to reward the broader "relationship" with the bank or broker rather than focusing on the value of the research services provided.

However, we would flag that increased scrutiny of what is and is not research will lead to the need for increased expenditure within the buy-side's CSA process and so could introduce unintended consequences.

One additional area for examination is whether the FCA wished to add to the definition of substantive research a requirement for it to be un-conflicted? In line with the broader thrust of the FCA's thinking, the determination of conflict should lie with the buy-side recipients of research, not with the originators. This would reinforce and promote the development of more un-conflicted research across the industry. If any providers wished to continue producing a service that the buy-side viewed as conflicted, the rules could ensure that such a service be seen purely as marketing and so could not be seen as chargeable.

Secondly, the definition of corporate access and the clarification that it does not automatically fall within the research criteria.

Euro IRP has long been concerned that major banks and brokers have been exploiting their corporate finance relationships in order to attract an unfair proportion of the research commission pot. This situation has been detrimental to the interests of the corporate themselves, as their access to investors has in part been determined by the highest bidder rather than by their underlying IR needs. In addition it has meant that research commissions have been used to reward concierge services rather than research. We therefore welcome the broad definition of corporate access and the onus placed on the buy-side to determine whether any elements of a corporate access service constitute research. And to ensure that voting systems focus on the quality of research only, rather than broader relationships, we would propose that they attest that the voting systems they operate reward substantive research only. To ensure that voting systems focus on the quality of research only, rather than broader relationships, we would propose that the buy-side are requested to attest that the voting systems they operate only reward substantive research.

Finally, the guidance on treatment of bundled services and the requirement that commissions only be used to pay for the research elements.

This we believe is a critical piece of the regulatory approach. Euro IRP is aware of the debate in the industry about the supposed difficulty of valuing research. Many points have been raised including the difficulty of menu pricing a broad research offering, the supposed need for auction pricing to ensure “appropriate” payment for scarce analyst resource and the undoubted fact that individual pieces of research can have wildly differing values to different clients depending on their investment approach and their portfolio position. However, the independent research sector provides clear pricing guidance to its clients based either on a pure subscription model or on the level of service provided, and the clients of the IRPs appear to have no difficulty in deciding whether or not to pay for such services. Valuation of a research service (rather than individual research pieces) is not overly challenging. Consequently, estimating the value of the research element of bundled services is also feasible. By clearly stating that such services need to be unbundled and priced separately the FCA will take a major step towards outlawing inappropriate cross-subsidisation of services.

One area that the CP does not address is the issue of VAT and bundled services. In PS05/9 the FSA stated that HMRC had confirmed that the VAT treatment of research would be unchanged under the proposed rule changes: “and research/advice services will continue to be seen as ancillary to exempt execution services when supplied under a contract for arranging transactions in securities.” Bundling in the PS05/9 context refers to the linking of zero-rated execution services with research, allowing IB/brokerage provided research to be considered VAT exempt (although non-execution providers such as IRPs consider themselves VAT liable). Bundling in CP13/17 primarily (but not exclusively) refers to the admixture of services that may or may not qualify as research (corporate access or data service for example.) These latter “bundling” examples have no VAT relevance. The industry needs further guidance on how rule changes may change VAT treatment of research and whether the IRP sector should be obtaining the same VAT exemption as their larger research competitors.

In producing this response we have taken cognizance of the recently published report *The Use of Dealing Commission for the Purchase of Investment Research* produced by the IMA. Euro IRP broadly supports the analysis and recommended actions contained in the report. We would wish to emphasise the need to ensure that “broker voting systems” should now be viewed as “research voting systems”. This cultural change should help ensure that the commercial separation of payment for execution services (based on best ex rules) and for research services (based purely on the evaluation of value added by the research service) becomes properly embedded in the industry, so reducing the cross subsidisation of services by the investment banks which, we believe, is one of the key causes of research market inefficiencies and associated conflicts of interest.

The primary concern that Euro IRP has with the current process is that our members are the most vulnerable to any major change in research commission availability. Our members are typically smaller than the banks/brokers and have no alternative revenue streams to maintain their businesses should the FCA’s actions produce a temporary commission (or broader research budget) drought as the buy-side reconsiders its approach. We are confident in the quality of our research and the robustness of our commercial relationships and believe that the IRP sector will flourish in the long term if the research market moves to a more level playing field. However, we hope that the FCA will monitor the situation closely as the consequences of its regulatory initiative unfold. In the short-term the IRP sector is more vulnerable to disruption than are the larger (and more conflicted) players. It would be the worst of unintended consequences if the IRP sector in Europe were decimated in the short term by measures designed to improve the long-term quality and value of research consumed by the buy side for the benefit of end-investors. As a result we recommend that any transition be set within a reasonable predefined and appropriate period for adjustment.

We will of course be available for any questions arising.

Yours sincerely,

Peter Allen, Chairman
The European Association of Independent Research Providers Limited