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2 March 2006

A Legal Update from Dechert's Financial Services Group

Reasonable Force: The New UK Regime for Dealing Commission

The new Financial Services Authority rules on use of dealing commission came into force on 1 January 2006. They replace the old soft commission regime, but have a much broader sweep, applying rules on permitted services and disclosure to full service brokerage generally.

Scope of the new regime

The rules are directed at asset managers who implement investment decisions through executing brokers, on behalf of their clients. On occasion an executing broker might itself come within the regime, but only where it delegates execution to a sub-broker, passes on the sub-broker's charges directly to its client rather than absorbing them itself, and receives goods or services from the sub-broker additional to trade execution. The rules apply to managers authorised by the Financial Services Authority and operating from within the UK. Unlike the US soft dollar regime; the scope of the rules is not defined by reference to the nationality of the customer, or to whether or not the customer is a mutual fund.

The rules apply to commission paid in respect of orders for equities and related warrants and options. They do not extend to bonds or derivatives business, chiefly because of the lack of an agency commission structure in these markets. Nor do they apply where the broker deals as counterparty, and not as the manager's fiduciary.

The rules only apply to brokerage costs which are paid out of the client's assets. A manager who chooses to pay brokerage costs with its own fees can do what it likes.

The move from Soft Commission to Dealing Commission

The old softing rules only applied where there was an arrangement in place between a broker and manager, under which the broker made available certain extra services. Usually the broker only committed to do this if the manager met certain transaction volumes, and soft commission is accordingly associated in the UK with formal arrangements of this sort. Only a relatively small part of the management market used these sort of arrangements, and most were untouched by the softing rules. Under the new rules, in contrast, no arrangement is required. The regime applies to any commission payments, where the price includes, as a matter of fact, services over and above pure execution. They therefore extend to any UK manager using "full service" brokerage – a far wider category than was affected by the old softing rules.

Under the old regime, managers were prohibited from opting out of best execution if they had entered into a softing arrangement. The wider scope of the new regime means this requirement is no longer strictly applied. Commission arrangements must not compromise the manager's duty to achieve best execution, but this is without prejudice to its ability to opt out of best execution in the normal way.

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Permitted services

The services which may be paid for out of dealing commission are restricted to execution and research. They must also assist the manager in the provision of its services to customers and not impair the manager's duty to act in its customers' best interests.

Research

Research is defined as material which is capable of adding value to investment decisions by providing new insights to inform investment managers when making investment decisions for customers' portfolios. It should represent original thought (not a mere repetition or repackaging of other material), and have intellectual rigour (not a mere statement of the commonplace or self-evident). Examples of "research" which would not meet these requirements are price feeds and historic price data which have not been analysed or manipulated to reach meaningful conclusions.

Quality of research is likely to be assessed on whether the product as a whole meets the quality tests, rather than on a formulaic or line by line basis. One established way for assessing this is to have a periodic vote by the individual portfolio managers as to which brokerage research they want to continue receiving. Of course, this means that future business is likely to be based on past quality, and will need to be periodically monitored to see that the assessment remains valid.

The research does not have to come from the executing broker itself. It is likely that increasing use will be made of shared commission arrangements, where the broker enters into a three way agreement with the manager and an independent research firm to pay for or contribute to the cost of independent research. Where research is received by a manager on an unsolicited basis and the manager makes no use of it, it may be thought that the dealing commission rules should not apply. However, where securities are actually bought on the back of that unsolicited material, there is an inference that (a) commission paid on the sale reflects the research cost; and (b) the material passed the permitted service test by adding value to the manager's investment decision.

Execution services

The general test for whether a service is permitted or prohibited is purposive – is it substantively used for permitted purposes?

To qualify under the execution head, the service must be linked to the arranging and conclusion of a specific investment decision which has already been made, and the point at which the resulting transaction is carried into effect or performed. A service which relates to the making of the initial investment decision, such as market information used in the decision-making process but which does not qualify as research, is not a permitted service. It is therefore necessary to test how the service is used. Where there are separate management and dealing teams a reasonable opening assumption may be that a news service used by the managers is unlikely to be permitted, and one used by the dealing team is probably legitimate.

Similarly, post-trade services such as ongoing custody or post-trade analytics are not permitted. The status of settlement services is currently a little uncertain. There are several different points at which the trade might be said to be concluded – contract, matching, confirmation, appropriation in the exchange clearing system, and finally entry on the companies register. Our own view is that permitted services ought to extend at least as far as the point of appropriation.

There are some theoretical questions about the difference between straight "execution" on the one hand, and an "execution service" on the other. For example, is a broker-dealer's willingness to switch from agency to principal-trading mode an instance of a service "bought" with brokerage commission, or an independent piece of market activity?

Certain services are expressly listed as not permitted:

- services relating to valuation or performance measurement
- computer hardware
- dedicated telephone lines
- seminar fees
- subscriptions for publications
- travel, accommodation or entertainment costs
- office administrative compute software
- membership fees to professional associations

- purchase or rental of standard office equipment
- employees' salaries
- direct money payments
- publicly available information
- custody services other than services that are incidental to the execution of trades.

Of these, computer hardware, dedicated telephone lines and seminar fees were permitted under the old regime. There is continuing argument over whether dedicated telephone lines should be included on the banned list, but the FSA is not yet persuaded.

The Disclosure regime

The manager must make adequate prior and periodic disclosure of any arrangements to purchase execution services or research with dealing commission. To be adequate, the prior disclosure must be made before business is commenced, or in the case of existing clients by 1 July 2006 (or if earlier at the time of the first periodic disclosure). Periodic disclosure must be made at least once a year. Prior disclosure must cover the firm's policy on receipt of commission-based services, including generally why the firm might find it necessary or desirable to use dealing commission in this way, bearing in mind the practices in the markets in which it does business on behalf of its customers. The content of the periodic disclosure is not specified, but the disclosure code developed last year by the Investment Management Association and the National Association of Pensions Funds is taken as a market model. It covers both prior (level One) and periodic (level Two) disclosure.

Under this model:-

Level One – a description of Investment managers' policies, processes and procedures in the management of costs paid on behalf of clients; the disclosure to be made on inception and annually thereafter. This includes describing the firm's policy on external research and how it is purchased.

Level Two – six-monthly client specific report on:

- the commission payments generated on the client's account and the rates at which they are charged;
- how the commissions have been used, including as split between commission spent on execution on the one hand and research on the other;
- a disclosure of equivalent information on a firm-wide basis.

The IMA model is designed for sophisticated pension scheme clients and goes further than the FSA requirements in several respects. It is not confined to equity business but also includes information on net trades and bond dealing, and contemplates six-monthly reporting, where only annual reporting is required. Managers who do not follow the IMA model must be able to demonstrate why they think their alternative form of disclosure is adequate. The Association of Private Client Investment Managers and Stockbrokers ("APCIMS") have suggested that a different approach is desirable for small private client portfolio managers, where the amount of third party commission is small and disclosure is unlikely to enable clients to influence transaction costs.

The move from soft commission to general commission disclosure means that managers who have not previously had to analyse their brokerage services firms will now have to do so. This may mean that, unless they have an established and detailed policy in this area, the Level One disclosure will be in pretty general terms, with the substantive disclosure being made at Level Two. This is supported by the fact that services provided will vary over time, and anyway the Level Two report will usually be viewed as a self-contained document rather than read in conjunction with the original statement.

Level Two disclosure appears on the face of it to require an exhaustive mathematical calculation of every commission payment and the related services split for the relevant period. However, brokers' own breakdowns are fairly "soft" data, and both the London Investment Banking Association and APCIMS have suggested that brokers should provide a forward-looking indicative research/execution split, rather than a pseudo-mathematical calculation of historic charges. Managers in turn are likely to make their own assessment of brokers' figures and other market information in order to reach a set of assumptions and policies which they can use to make the level two disclosure. APCIMS has expressly said that it envisages firms setting their own in-house disclosure standards in relation to brokerage split, in the light of figures used elsewhere in the investment management industry. In light of

this it is of interest to note that the typical execution and research cost-split seems to be coming out at around 60/40.

The International Dimension

As with the old soft commission rules, the new regime has been thought through in primarily domestic terms, and the international implications are given only marginal attention.

Delegated management

Where a UK principal manager delegates to a sub-manager the sub-manager is also required to comply with the dealing commission regime, otherwise the FSA rules could be avoided simply by washing the business through another contractor. The sub-manager must similarly comply with the regime, treating the principal manager as its client. This applies even where one of the parties is outside the UK. There are issues here which still need to be addressed but it appears that, for example, a UK principal manager would have to require a non-UK sub-manager to restrict the activities of its brokers and provide disclosure reports to the principal manager, so that these can be disclosed in turn to the UK client. Similarly, a UK sub-manager would have to make the UK-required disclosures to a non-UK principal manager and operate the UK restrictions, even though the principal manager had not asked for them and might not want them.

Use of overseas brokers

UK managers are required to restrict non-execution services, and obtain a price breakdown from all brokers, including non-UK brokers. Overseas brokers are unlikely to be familiar with the new rules, and may see limited benefit in helping UK managers to meet the new requirements. The FSA appears to accept this in principle, and with it the likelihood that information from overseas brokers will not be as complete or reliable as from UK brokers. However, managers in this position should ensure that they can show they have taken reasonable steps to obtain the right information. As we understand it, these reasonable steps stop short of inventing information to fill in the gaps where real information is not available. The FSA has indicated that the disclosure must, if it is worth providing at all, be of some use to the customer.

It is unclear (as indeed it was under the old soft commission regime) just how the FSA's restrictions on permitted services are meant to apply to international management groups. Clearly a UK affiliate should not be receiving prohibited services directly, but what if non-qualifying material is received elsewhere in the manager's group and made available to the UK affiliate via a central data base? A narrow interpretation would suggest that the UK affiliate should set up separate broking arrangements from the rest of the group; or perhaps it might be allowed to use the same brokerage and pay the same fees as the rest of the group so long as it did not use any of the prohibited services. Even on a strict view it would presumably be OK for the UK firm to receive prohibited services so long as they were not paid for by UK customers.

Conclusion

Now that the regime is under way the indications are that the FSA is taking a genuinely industry-led, pragmatic approach, and not seeking to be too heavy handed. The success of this will depend on all firms meeting their side of the bargain, and taking a responsible approach to the service classification and client disclosure.

Remember:

- New customers must receive Level One disclosure immediately.
- Existing customers must receive their first level One and Level Two disclosures by 1 July at the latest.
- There is transitional relief for any soft commission agreements in place on 1 January – until 30 June 2006.

Practice group contacts

For more advice on any of the above, please contact either of the lawyers listed or the Dechert lawyer with whom you regularly work.

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