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HERE'S THE THING!

Does it bother you that dealing commissions are used to pay for investment research?

Fifteen years ago, Paul Myners challenged the UK investment industry at several different levels on its lack of ***transparency***. His work yielded some positive and still evolving regulatory change across Europe, most immediately in the form of MiFID I (Markets in Financial Instruments Directive – 44 pages published April 2004). MiFID I promised transparency regarding the use of dealing commissions to pay for investment research.

Today, almost 12 years later, not much has changed.

PART 3 OF OUR TRANSPARENCY TRILOGY

A long, long time ago, back in the year of our Lord, 2005, I was happily engaged in a small, independent and very successful global investment broker-dealer and consulting firm. But the winds of change were upon us, and status quo seemed a weak response. So together with the head of our trading operations, I undertook some extensive travel to meet with a goodly number of our investment manager clients and prospective clients in Europe and North America so that we might better understand the lay of the land and accordingly develop and implement a new business strategy for the decade ahead. One of the key catalysts for change (and for our trip) at that time was the April 2004, 88-page publication known as "MiFID I"[i] and related initiatives by the UK Financial Securities Authority (now the Financial Conduct Authority or "FCA") and other European securities commissions. These regulatory undertakings promised real change on the transparency front. Of particular interest to us were regulator calls for more transparency regarding the convention whereby investment management firms pay for their research through dealing commissions, i.e. with their client's money. This practice, politely referred to as "bundled commissions", sees brokerage firms bundling a variety of services together for a single fee expressed in commission dollars. Investment management firms that purchase these bundled services then allocate the total commission costs across their client accounts. But no one prices the *individual* services separately, so no one is really capable of verifying the value-added provided for fees assessed. I have long wondered what other industry we know that, on top of its announced fee for services, maintains the authority to use its client's money to pay for its own cost of goods sold? But I will leave that alone for now. Clearly, with bundled commissions, the brokers win and the clients lose. But what about the investment managers? Well, they win too because regardless of how much they are charged for broker-provided research, the client pays for it anyway.

Our mindset at the time of our research trip, was that of an "execution-only" broker, which we were. Execution-only brokers seek to be paid a competitive commission rate for securities trades that they executed; they offered no securities research. As such, our operating costs were much lower than those of the full-service (read research-providing) brokers and we believed that if clients were made aware of the individual service charges that were being posted to their accounts, we could readily demonstrate our capacity for providing best execution at much lower commission rates than those of our larger competitors. Simple enough in theory; less so, as we learned, in practice.

Post MiFID I, UK and European regulators moved to require investment managers to regularly report total commission costs to their clients, and to separately identify allocations for execution and research. Compliance followed in practice but not in spirit; brokers balked at the required cost accounting effort, investment managers were inconsistent about reporting methodology and most investors didn't bother to use the new information that they now had access to. The result? No joy for our upstart, "execution-only" brokerage firm and ten years later, "Plan B" - in May of 2014, 148 pages of MiFID II[ii]!

There is much that goes on in the investment world that is not transparent and that needs reworking in some manner. Here in the JOURNAL we can do little more than point to certain of the more obvious abuses. The practice of using dealing commissions, i.e. the client's money, to pay for investment research, is one such issue.

MIFID II – THE SOLUTION?

I fear for MiFid II. The document addresses so many industry issues that it will not be hard to signal success with the resolution of certain key issues while others go partially or in some other manner, unsatisfactorily resolved. Be certain that the vested interests are lobbying and delays in implementation have already been conceded, with more expected to come. Skadden, Arps, Slate, Meagher & Flom LLP advises[iii] that MiFID II is expected to come into effect in or around January 2018, a year later than originally planned and other media sources report likely further delays.

But hope springs eternal, and today our hope lies with the UK's FCA. The FCA has courageously experimented with transparency and reporting alternatives in an attempt to resolve the issue without unnecessarily disruptive change. In their more recent discussion papers however, they have acknowledged that these attempts have not worked. Now, with the benefit of substantial opinion and idea gathering research, and always respectful of varied interests within the industry and across the economy at large, the FCA has set themselves down firmly in the camp of believers who profess their faith in the idea that reforms are necessary "to separate the receipt of research by investment managers from execution arrangements". In a Discussion Paper published February 2015 and entitled "Feedback statement on DP14/3 –Discussion on the use of dealing commission regime" the FCA concludes:

- "We believe ESMA's[iv] proposals will better align investment managers' incentives to control costs and be transparent with their customers over charges for external research, and remove the inducement and conflicts of interest created by bundling research into execution arrangements with brokers. It will lead to pricing for research by brokers and other providers, encouraging a focus on quality and value for money in this market that will result in more effective competition in the interests of consumers."

Skadden, Arps however, warns that "at the time of writing, it is expected that ESMA's original proposals will be watered down to a position slightly more palatable to the investment management industry."

CONCLUSION:

This is how it plays out across the pond. But what of this side you ask? As I understand it, North American regulators are focused elsewhere.

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OUR HOPE:

Honestly, fairly and professionally . . .

Intuitively, separation of the receipt of research by investment managers from execution arrangements is the optimal solution. In light of the most fundamental industry principles that require that, when providing investment services to clients, investment firms act honestly, fairly and professionally, it is the *only* solution. Let's stand together with the FCA on this issue and hope that our North American regulators follow suit.

This is our hope.

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[i] http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1398325978410&uri=CELEX:02004L0039-20110104
[ii] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0065
[iii] http://www.jdsupra.com/legalnews/mifid-ii-expected-to-have-significant-32937/
[iv] "ESMA" is the European Securities and Markets Authority, an EU financial regulatory institution located in Paris whose final advice to the European Commission (EC) on the delegated acts to support the revised Markets in Financial Instruments Directive (MiFID II), was published in December 2014.