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By email to: **cp13-17@fca.org.uk**

25 February 2014

Dear Mr Wreglesworth

Re: FCA Consultation Paper (CP13/17): Consultation on the use of dealing commission rules

The City of London Law Society ("**CLLS**") represents approximately 15,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. This response in respect of the FCA's Consultation Paper on the use of dealing commission rules (CP13/17) (the "**Consultation**") has been prepared by the CLLS Regulatory Law Committee (the "**Committee**").

The Committee generally expresses no views on pure "policy" issues, for example, in this context as to what types of service should be capable of being purchased with commission. We focus our comments on legal issues relating to and legal implications of proposals. On that basis, the Committee has significant concerns in relation to the following aspects of the proposals:

- the presentation of the changes as being a "clarification" and as being consistent with the "intention behind the original regime". These are clearly substantive changes to the rules which have a number of implications, including on the requirement for an Article 4 notification;

- the introduction of a new definition relating to research; and

- the definition of corporate access.

Further details are given in the responses below to the specific questions posed at Annex 3 of the Consultation.

Q1: Do you agree with the detail of the rule and guidance changes we have proposed?

"Clarification" versus rule change

There are a number of references in the Consultation Paper which state that the changes are clarificatory. For example, paragraph 1.3 states:

> "Our proposals are intended to clarify the criteria for research under our rules to help firms make better judgments about what can be paid for with dealing commission... The proposals are consistent with the original intention of the regime, and are designed to provide clarity and improve judgments made in relation to these rules."

There are numerous similar references.

We do not agree with the explanation given for the proposed changes as we believe that it misrepresents the nature of the change being made. This is important because it is relevant to the interpretation of the rules as they currently stand (which may be important to firms in their engagement with the FCA), it is also relevant to the judgment as to whether the changes need notification under Article 4.

We fundamentally disagree therefore with the assertion in paragraph 2.36 that the changes do not impose new requirements on firms, they do. It is very disappointing to find the changes characterised in this way, and there is no need to do so. If the FCA wants to change the rules it can do so. It is entirely possible that a firm's practices do not comply with the existing rules, but it is also entirely possible that a firm's practices are compliant with the existing rules, but that they will need to change in the light of the changes proposed. This is a direct result of the change in the nature of the evidential rules, and not a result of a lack of drafting clarity in them.

These points are relevant both to the views taken by the regulator of current practices, to the cost benefit analysis and in our view proposals of this significance should be notified under Article 4.

We make these points because the changes to the rules have the following effect:

- the legal status of the evidential rules in 11.6.4E and 11.6.5E has been changed. This is not a clarification, it is a substantive legal change which affects the rights and obligations of firms. Under the previous formula, a rebuttable presumption was created that a firm which met the requirements of the evidential provision could rely on it as tending to establish compliance with the rule. This clearly and deliberately left open the possibility that a firm could comply with the rule without meeting any or all of the tests in the evidential provision. The change means that, unless a firm complies with all of the tests in the evidential provision, then there is a rebuttable presumption that the rule has been contravened. The current formula was deliberately chosen because of the difficulty in establishing a suitable formula for defining "research" of the kind which was considered appropriate for purchase with dealing commission, due to the wide range of research services, the method of their delivery and other characteristics;

- the change in formula in 11.6.5 E (d) is also a substantive change to the scope of characteristics required for eligible research;

- 11.6.9G is also a substantive change. The deletion of the words "research can include, for example the goods or services encompassed by *investment research*" and the replacement with the concept of "substantive research" seems to open up the possibility that some *investment research* is not "substantive research", which would not have been the previous understanding and requires extraordinarily difficult judgments to be made on a case-by-case basis; and

- the removal of the "reasonable grounds to be satisfied" wording from the previous rule makes what is a relatively delicate judgment (whether research is substantive or not) into a strict liability offence and this is a substantive change and one which we do not think is appropriate in this context.

It is clear that the FCA disagrees with the judgments reached by some investment managers as to what constitutes "research" and it is obviously open to the FCA to redefine "research". This is what is done through the proposed changes, and they are not, for the reasons given above, either a clarification or a representation of the original intention.

It was entirely open to the FSA to choose the evidential status of the rules when they were made, and it deliberately chose their current status.

It was also well aware and expressly acknowledged that, used properly, the facilities available through what loosely refers to as "market data services" could qualify as "research". Again it is clear that the FCA does not think that firms have carried out a proper scrutiny of their use of these services, but this is entirely different from saying that such services do not constitute research under the current rules, or that only limited parts of these services meet the criteria for exempt research. It has previously been acknowledged that the issue was whether and to what extent the client used those parts of the services which meet the criteria. These services have many different aspects not all of which will be used either at all or to any significant degree. The question is what is the service that is actually used, not what are all of the services that could potentially be used. This is why firms were expected to carry out a proper assessment of their use of these services.

New Research Definition

We do not support the introduction of yet another definition of "research". There are already multiple overlapping definitions, including investment research and research recommendations, with which firms have to grapple. We also think it is possible for high-quality research to be based otherwise than on "analysis or manipulation of data". We therefore do not see any need for the introduction of yet another definition in relation to research. We agree that it is entirely possible for research within the meaning of the changed 11.6.5E to be potentially wider than "investment research", but we see no need for yet a further definition. If the FCA changes the rules as it proposes then 11.6.5E will essentially be the definition that is relevant.

Further, the assumption behind this rule change is that there must be a category of research which amounts to non-substantive research. The sell-side will be responsible for considering whether it produces non-substantive research. Investment managers will be responsible for considering whether they are consuming non-substantive research. In order to protect themselves from an accusation that non-substantive research is being consumed out of commissions, we think it likely that investment managers will pay a small sum for such research in order to establish that this is not the case.

Corporate Access Definition

We also consider that the definition of "corporate access" is too broad and is also unnecessary. A clear statement by way of guidance as to the FCA view on corporate access is all that is required. If it is retained as a concept then both the definition and the accompanying text need to ensure that:

- it is clear that a firm cannot use client commission to pay a broker or another person of the kind referred to in 11.6.3R to provide it with corporate access;

- nothing in the rules prevents an investment manager from meeting with or having access to issuers, the question in each case is whether the investment manager has paid for such access through the payment of dealing commission; and

- it should also be acknowledged that certain forms of corporate access come without any charge at all – for example, meetings with issuers in relation to specific transactions such as proposed rights issues etc. In addition, many corporate access services are provided by sell-side firms to a corporate, e.g. in the corporate finance type situations referred to above. Without such an acknowledgement there must be a risk that firms will be advised to make some form of nominal payment to make it clear that it is not paying for the service out of dealing commissions.

Q2: Do you agree with the justification and cost benefit analysis for these changes?

- The Committee does not agree with the justification for the changes. The FCA states that it is clarifying the rules, however it has not provided any greater clarity.

- As a legal point the Committee is of the view that the FCA's proposals *change* the rules, rather than merely *clarifying* them (as outlined above), which raises issues concerning the Article 4 notification process.

No, for the reasons explained in Question 1 above.

Q3: Do you believe there are likely to be any material, incremental costs or benefits which we have not considered here?

Yes, for the reasons given above.

If the FCA would find it helpful to discuss any of these comments then we would be happy to do so. Please contact me in the first instance by telephone on +44 (0) 20 7295 3233 or by email at margaret.chamberlain@traverssmith.com.

Yours sincerely

pp. Lauren Causon

Margaret Chamberlain

Chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

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David Berman (Macfarlanes LLP)
Peter Bevan (Linklaters LLP)
Simon Crown (Clifford Chance LLP)
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