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Discussion Paper DP14/3 – Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research

Dear Sirs,

We welcome the publication of Discussion Paper DP14/3 - *Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research* (the "***Discussion Paper***" or "***DP***")[1] and we appreciate the opportunity to provide you with our comments.

Markit is a provider of financial information services to the global financial markets, offering independent data, valuations, risk analytics for internal capital models, and related services across regions, asset classes and financial instruments. Our products and services are used by numerous market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities.[2]

Markit has been actively and constructively engaged in the debate about regulatory reform in financial markets, including topics such as the implementation of the G20 commitments for OTC derivatives and the design of a regulatory regime for benchmarks. Over the past years, we have submitted more than 100 comment letters to regulatory authorities around the world and have participated in numerous roundtables. We also regularly provide the relevant authorities with our insights on current market practice, for example, in relation to valuation methodologies, the provision of scenario analysis, or the use of reliable and secure means to provide daily mid-market marks. We have also advised regulatory authorities on appropriate approaches to enabling a timely and cost-effective implementation of newly established regulatory requirements, for example through the use of multi-layered phase-in or by providing market participants with a choice of means for satisfying regulatory requirements.

Introduction

We welcome the publication of the FCA's Discussion Paper and we appreciate the opportunity to provide you with our comments. Our views are based on the experiences that we have gathered over the years by offering the Markit Commission Manager and the Markit Vote services to the industry, both of which are directly relevant in the context of the DP:

[1] FCA Discussion Paper DP14/3 "Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research." July 2014.
[2] Please see www.markit.com for further information.

- ***Markit Commission Manager***[3] is a web-based tool that is used by investment managers to manage the research commissions that they generated with their brokers by virtually aggregating commission credits. This solution that has been available for several years is currently used by over 100 buy-side clients and more than 25 sell-side firms in Europe, North America, and the APAC region. The reconciliation engine and detailed matching criteria that are embedded in the platform help streamline the reconciliation process and increase operational efficiency by allowing customers to manage commissions via a single platform.

- ***Markit Vote***[4] is a web-based solution that enables buy-side firms to evaluate their brokers and research providers in a comprehensive, granular, and auditable manner. The platform allows fund managers to vote on a granular level, for example on the level of teams, asset classes, and regions. It includes an administrative interface for buy-side firms to set up the vote based on firm-specific configurations. It also provides a set of broker scorecards and commission reports that can be generated by team and downloaded in various formats.

Comments

- ***Q1: Do you have any comments on our analysis on the potential impact of unbundling payments for research from execution arrangements, based on MiFID II proposals?***
- ***Q2: Do you have any analysis that would help inform our view of possible benefits or costs of extending requirements in MiFID II to cover all research goods and services?***

We appreciate the analysis that the FCA has performed as part of its Thematic Review (the "***TR***") on the current use of dealing commissions and related tools such as CSAs and Broker Vote. However, based on our experience in providing such services to the buy- and sell-side communities in Europe and the United States for many years we believe that it would be beneficial for the FCA's findings of the TR to be further analysed and put in context. Please therefore find our comments below.

General findings of the TR

The DP states that out of the 17 Investment Managers ("***IMs***") that were covered in the TR a total of 11 did not have research budgets[5] and that "a link between levels of research payment and trading activity remains embedded in many firms' processes."[6]

Whilst these statements might be accurate for the sample of firms that were included in the TR we note that the FCA also acknowledges the progress that the industry has made over the last several years in its dealing commission related practices.[7] We believe that such progress is evidenced by the fact that some IMs now set research budgets[8] and switch from a full research commission rate to an execution-only rate once those budgets are reached. Whilst the adoption of such practice on its own might not address all of the FCA's concerns yet we note that the FCA highlights it as meeting its standards in the DP.[9] We further believe that the broader use of commission manager products in general demonstrates a level of sophistication of the IM

[3] http://www.markit.com/Product/Commission-Manager
[4] http://www.markit.com/Product/Vote
[5] DP 14/3, Par. 1.26.
[6] DP 14/3, Par. 1.29.
[7] "Many of the firms we visited had made improvements since November 2012 …", DP 14/3, par. 1.26
[8] Which are typically set by quarter and/or by broker.
[9] "There were clear views on some of the better controls applied by some IMs, and which most felt should be more widely adopted, including: … Research budgets are managed through the careful use of CSAs and management of execution rates, e.g. moving to execution-only rates (from bundled rates) with a broker as soon as the research cap has been reached in a set period of time." DP 14/3, Par. 4.12.

community and should be regarded as evidence that IMs are taking the process seriously including adherence to guidelines and best practices.

We also believe that the FCA should recognize the challenges related to setting a budget for research whilst the current setup of the research business, if appropriately managed, provides value to IMs (and their clients) without the need for an upfront agreement on a payment for research. Specifically, it is costly for the sell side to build and support a comprehensive and fully global research platform that its clients expect. Brokers generally deliver research to their clients with the expectation that they will value it based on its effectiveness and usefulness. Specifically, if an IM follows the advice of a specific broker and acting on the research results in significant performance gains for that IM, it would compensate the research provider accordingly through increased trading activity. In contrast, for research that has proved to be ineffective or not useful the investment manager will typically adjust his commission spend accordingly. The FCA should recognize that, on this basis, the incentives of the IM and its clients are indeed aligned, i.e. the IM would make payments only for value-creating (or outperformance-generating) research. Commissions will hence provide an effective feedback mechanism to the research provider enabling those in turn to not just support but also design and adjust their global research platform.

In contrast, where fees for research were negotiated and agreed between the research provider and the IM ex ante, the research provider has no opportunity for an outsized economic gain in instances where its research produces significant gains for the IM. We are concerned that in such model the resulting economics might no longer support the long-term cost of building and supporting the research business. Forcing change could result not only in an initial disruption of research provision, but it would most likely lead to a more general level of under-production of research long term, to the detriment of IMs and their clients.

Commission Sharing Arrangements

In the DP the FCA mentions some “weaknesses” and “issues” that it has identified in relation to the use of Commission Sharing Arrangements (“***CSAs***”):

- The DP states that CSAs are “complex and costly to administer”.[10] We respectfully disagree with this statement. Based on our experience in providing tools that have been designed specifically to ensure the efficient functioning of CSAs from an operational perspective we are unsure what the FCA is referring to. We believe that the CSA payment process nowadays is both as fast and efficient as it can be.

- The FCA voiced concern in relation to the fact that the broker that provides the CSA “can administer the pot in a way that disadvantages their research competitors”, e.g. it “by delaying payments” and it would know which of its competitors receives CSA payments”.[11] Whilst these issues might exist in theory, we do not believe that they really matter in practice. For example, we have not seen any evidence that brokers would routinely delay payments to other brokers as a matter of practice or intent. Further, whilst the use of CSAs might provide some employees of brokers with information about which other research firms the IMs are paying, we believe that such potential conflicts of interest would be appropriately managed by existing policies and procedures within the individual firms. On that basis, we believe they should not be used as reason against the use of CSAs in general.

- In relation to the overall level of use of CSAs, the FCA found that “many firms still pay more commissions in bundled rates to brokers without using CSAs”, that the use of CSAs “has plateaued in recent years”, and

[10] DP 14/3, Par. 4.26.
[11] DP 14/3, Par. 4.26.

that it is “more common among larger clients” but “less so in a long tail of IMs”. [12] We disagree with the view that the use of CSAs has plateaued. As a matter of fact, since we launched our Commission Manager product several years ago the number of clients has roughly doubled every year. However, we do generally agree with the FCA’s observation that the use of CSAs is more common amongst larger IMs. This can be explained by the fact that the larger IMs are usually more advanced in implementing changes to their procedures, often simply because they have more resources available to implement change. However, the FCA should note that the process of setting up a CSA is very efficient, it requires only limited resources, and it can be completed within days, if not even on a same day basis if required.

Broker voting tools

The DP states that a broker voting process is “used by majority of firms”. However, it also concludes that the broker voting process did “not directly assess the monetary value of the research they are receiving”[13] and that it is hence only used as a “relative ranking tool”.[14] The FCA further found that the broker vote process “often lacked detail in recording what the fund manager was valuing when voting for a particular research provider” and that the “vote represented a percentage of the CSA balance”.[15]

We generally agree with the FCA’s observations in relation to current market practice in relation to broker vote tools. This is because the fundamental tool for actually paying research providers once the vote is cast is still the dealing commissions that have accumulated via a different process, namely the amount of trading activity. However, we believe that the FCA should not use this as a reason to question the relevance and usefulness of the broker vote mechanism per se. Specifically, existing broker vote tools[16] already provide IMs with the option to use either points or actual GBP amounts for their vote and, in any case, point values or scores can be easily translated by the IM into an actual GBP amount or commissions at the manager’s discretion.[17] The decision how the IM translates the results of a broker vote into actual compensation for its brokers if up to them and will be made outside of our system. Importantly though, our system provides a framework that allows IMs to make these determinations in a transparent, auditable, and standardized manner.

The DP states that the broker vote process encourages brokers to maximize the number of “touch points” and to provide “waterfront coverage”.[18] We do not agree with this perspective as the Broker Vote process is geared towards the buy side and provides IMs with a feedback mechanism to the sell side with a strong focus on measuring the actual “value” of the research, on that basis it will reflect not just the quantity but also the quality of what they have been provided with by their research providers. In any case, we believe it might be useful to provide more education to IMs on how to manage this process with a high level of engagement with industry participants engaged in the process.

[12] DP 14/2. Par. 4.24.
[13] DP 14/3, Par. 3.18.
[14] DP 14/3, Par. 4.29.
[15] DP 14/3, Par. 3.19.
[16] For example, Markit Vote is a web-based solution that enables buy-side firms to evaluate their brokers and research providers in a comprehensive, granular, and auditable manner. The platform allows fund managers to vote across teams, asset classes, and regions. It includes an administrative interface for buy-side firms to set-up the vote based on firm-specific configurations. It also provides a set of broker scorecards and commission reports that can be generated by team and downloaded in various formats.
[17] On that basis we believe it would be fair to say that existing broker vote tools are already capable of assigning “a clear monetary value to each vote”. DP 14/3, Par. 4.12
[18] DP 14/3, Par. 4.65.

Conclusion

We believe that many of the FCA's concerns in relation to conflicts of interest that IMs are exposed to and how they are currently managed are generally valid. Whilst we encourage the FCA to acknowledge the extent to which industry practices have evolved positively in this respect we also understand the FCA's concern that such change is not fast enough.

However, based on our experience, we believe that the FCA's concerns would best be addressed by ensuring that the necessary change in IMs practices occurs *within* the already existing framework. Specifically, the FCA should recognize the current model of research provision rather than forcing disruptive changes onto the market place that could have unpredictable consequences. We believe that the FCA could achieve its objectives in a timely and less disruptive manner by requiring IMs to adjust their practices within a certain time frame. Specifically, the FCA could require IMs to a) establish quarterly research budgets targets, b) use CSAs,[19] c) use broker vote mechanisms to determine the actual GBP amounts to be paid to specific research providers within those budgets, and d) switch to execution-only fees once these budgets have been reached.

* * * * *

We hope that our above comments are helpful to the FCA. We would be more than happy to elaborate or further discuss any of the points addressed above in more detail. In the event you may have any questions, please do not hesitate to contact us.

Yours sincerely,

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[19] DP 14/3, Par. 5.8