LCP's response to FCA Consultation 24/7

Payment Optionality for Investment Research

3 June 2024

This document sets out LCP's response to FCA Consultation 24/7: "Payment Optionality for Investment Research" published in April 2024, which addresses the creation of an additional option for paying for research, namely using a bundled payment for trade execution and research.

Executive Summary

Who we are

LCP is a firm of financial, actuarial, and business consultants, specialising in pensions, investment, insurance, energy, health and business analytics. We have around 1,100 people in the UK, including over 170 partners and over 300 qualified actuaries.

Our core business is the provision of actuarial, investment, covenant, governance, pensions administration, benefits advice and directly related services. About 80% of our work is advising trustees and employers on all aspects of their pension arrangements, including investment strategy and selection of investment managers. The remaining 20% relates to insurance consulting, energy, health and business analytics.

Our high-level comments on the consultation proposals

Overall, we are not supportive of this new proposal. We believe there is a significant risk of financial loss to clients through their assets being used to purchase unnecessary and duplicative research. We do not consider the proposed guardrails to provide sufficient protection.

We believe that the 'bundling' of payments for third-party research and execution services will significantly elevate the risk of an 'agency problem' – for example, the investment manager spending clients' money without a proper evaluation of the value of the research received. This will raise costs for clients with little added benefit to them.

Although we accept this proposal as an operational requirement, we believe clients should be rebated for the cost of the research charged in a bundled way (where there is no agreed Research Payment Account).

If the consultation's proposals are adopted, we believe asset managers should:

- be required to give a long notice period for implementation;
- provide a breakdown of costs between execution services and research payments on request; and
- disclose either the estimated annual costs for research paid from client assets (where there is less than a year of implementation) and, once operational for one year or more, the historical costs **whenever and wherever** the investment manager's fee is shown.

Question 1:

Do you agree with our proposal to create additional payment optionality for investment research?

A qualified no.

Research is intrinsically part of the asset management service provided by investment managers. The cost of research should, we believe, be a cost to the asset manager's P&L. 'Bundling' commission payments leads to the client paying for this research from their own assets, and therefore an additional cost to the headline asset management fee.

We believe that the headline fee for the asset manager should cover the services the asset manager provides. The asset manager receiving other services paid from client assets obscures the true cost of asset management, and reduces investors' ability to compare the cost and, therefore, the value of asset managers' services.

The asset manager is the expert in judging whether the research it receives is good value for money. Introducing bundling of research payments is likely to lead to asset managers being less selective about the research they need to provide their service and hence to the purchase of unnecessary and low-value research – an agency problem.

We understand the global nature of the asset manager and broking industry and that from an operational perspective it is impractical for UK asset managers to stand-alone and not be able to pay bundled commissions. **Our view is that the part of the commission related to research should be rebated to the client whose assets were traded to generate the research commission** (where there is no agreed Research Payment Account)**.** This effectively means that the asset manager would continue to pay for the research from its own P&L.

Question 2:

Would you be likely to take advantage of the proposed new payment option?

We do not provide investment management services. This question does not apply to LCP.

Question 3:

Do you have any views on key indicators that could act as success measures for the outcomes we are looking to achieve?

No view.

Question 4:

Is the proposed new payment option and associated guardrails likely to be more efficient and adaptable than existing options for small, fast-growing or new entrant firms, or for existing users of RPAs?

No view.

Question 5:

Do the guardrails we are proposing around firms' use of the proposed payment option secure an appropriate degree of protection for consumers?

No.

Before MIFID II came into effect, charging for research through bundled commissions created an agency problem as the costs for research were not controlled properly and unnecessary research was produced and paid for (ultimately by the end investors).

We do not see the proposed guardrails as sufficient protection against this problem reoccurring. Our alternative proposals would be:

- A requirement for investment managers to inform clients they intend to start using bundled commission when trading the client's assets, with at least six months' notice.

- Disclosure of detailed information on the costs of, separately, execution and research as part of standard reporting, on request.
- Disclosure of the historical costs from research commission payments, or – where there has been less than a year of implementation, or historical data is expected to be a poor indication of the future – the expected future anticipated costs from research commission payments. This should be prominently disclosed whenever and wherever the asset manager's headline fee is published.

Question 6:

Is the proposed new payment option and associated guardrails likely to facilitate operational efficiencies via increased alignment with the requirements of other jurisdictions when purchasing research from overseas providers?

No view.

Question 7:

Do you agree with the findings set out in the Analysis section of this consultation paper?

No overall view.

We find the argument that bundled payments provide a public good to be unproven. Investment management is highly competitive and, arguably, the ultimate manifestation of a capitalist market. To assert that it requires assistance as a public good lacks credibility.

We highlight the finding under paragraph 3.14 of the consultation – our emphasis:

"They [Jackson & Zhang 2022 and 2023] also conclude that there is no evidence that increased research expenditure under bundled commissions actually promotes new research, rather than **generating marginal research in areas already adequately covered** or increasing the compensation of existing research analysts in such areas."

The requirement that asset managers pay from their own account has, in our view rightly, led to only valued research being produced and bought.

Factual information on listed companies is available for free on many websites. The provision of additional financial data is unlikely to be of additional public benefit.

We believe that the market for research received by asset managers is highly-informed, and expert buyers have plenty of choice to select an external source or determine that it can be done better in-house. These firms are well placed to judge which research is useful and which is not and make a commercial decision to purchase it, or not. Research providers producing output that is not purchased by these expert buyers are clearly not adding value.

Question 8:

Are there any features of the proposed payment option and associated guardrails that would positively or negatively impact its take-up by firms?

No view.

Question 9:

Do you agree with the proposed addition of short-term trading commentary and advice linked to trade execution to the list of acceptable minor non-monetary benefits in COBS 2.3A.19R(5)?

No view.

Question 10:

Do you agree with the deletion of the option for bundled payments to purchase research on companies with a market capitalisation below £200 million from the list of acceptable minor non-monetary benefits in COBS?

No view.

Question 11:

Are there any further comments you wish us to consider while finalising these proposals? If so, please include here.

We note the comment in paragraph 3.46 around the growth of in-house research capabilities and the difficulties of quantifying this growth. Many of the quantitative measures of research coverage look only at external analyst coverage.

Question 12:

Do you have any comments on our cost benefit analysis?

No.

Question 13:

Do you hold any information or data that would allow assessing the costs and benefits considered (or not considered) here?

When the MIFID II rules were introduced, we asked managers what the effects of these would be on their business. The vast majority claimed that they would have very little effect as most of the research that was truly adding value was done in-house. Some said they would need to pay for relatively low value provision of financial information and models of companies' accounts. None suggested they relied heavily on externally purchased research.

From our experience, since the introduction of MiFID II most asset managers are not using much external research. However, assuming that the decision is to proceed with the consultation's proposal, we do expect that competitive cost pressure will lead to many managers re-introducing bundled research payments over time.

Concluding comments

We accept that bundling research costs may be operationally necessary to allow UK managers to receive research from global providers, and the UK cannot stand alone if research is, in some areas, only available through bundled commission payments.

Our view is that bundled commission should be operationally permitted, but only as a step to it being ultimately paid for out of the P&L of the investment manager. We propose that the part of commission paid that covers research services should be rebated back to the client – where there is no agreed Research Payment Account. This should be relatively straightforward to implement since the payment is associated with a transaction of the client's assets.

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