EU's New Regime on Payments for Research, Use of Dealing Commissions

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The MiFID II regime will have ramifications for buy-side global asset managers and sell-side research providers relating to use of dealing commissions and cost allocation for research expenditures.

By far the most controversial area of the European Union's Markets in Financial Instruments Directive II (MiFID II) reforms has been that relating to the methods of payment by portfolio managers for research produced by investment banks, brokers, and independent research providers. This reform should come as no surprise to the industry; it had long been foreshadowed in the United Kingdom by the Financial Conduct Authority (FCA), which in November 2012 highlighted the conflicts of interest faced by the UK asset management industry following the regulator's thematic review from June 2011 to February 2012 on the arrangements UK portfolio managers had in place for managing conflicts of interest—including with specific reference to the use of customer commissions.

In October 2013, FCA announced that it was carrying out a wider review on whether reform was needed to the use of dealing commission (formerly known as "soft commission") regime in the UK "to deliver a more transparent and efficient asset management sector for the benefit of end investors". Following its further thematic review from November 2013 to February 2014, FCA published a discussion paper in July 2014 which featured FCA's conclusions that

- too few firms apply sufficient rigour in assessing the value of the research services they use;
- there is a lack of price transparency in the market for research;
- the bundled supply of execution and research by brokers makes price discovery difficult;
- unbundling research from dealing commissions would be the most effective option to address the impact of the conflicts of interest created for portfolio managers by the use of a transaction cost to fund external research; and
- unbundling would drive more efficient price formation and competition in the supply of research, removing current opacity in the market.

On 3 March 2017, FCA issued a report which concluded that investment managers continue to fail to meet FCA expectations on use of dealing commissions. Broadly, the report found that the majority of the 17 firms visited were falling short on assessing whether their research is substantive, how much of their dealing commissions went towards paying for research, and whether they were spending more of their customers' money on it than necessary. FCA noted that a few firms in the sample now pay for research from their own resources and that firms that complied with the use of dealing commission regime had seen a drop in the dealing commissions spent on research, which FCA says feeds directly into better investment performance for customers.

Fast forward to April 2017, and it is clear that whatever Brexit proves to mean for the United Kingdom and the remaining EU member states, it will not likely result in a wholesale abandonment by the United Kingdom of the new research payment regime delivered (with the UK present as midwife) under MiFID II and scheduled to take effect on 3 January 2018.

The new regime under MIFID II

MiFID II significantly builds on the existing MiFID I inducements standards. For portfolio managers (and providers of independent investment advice), it bans the receipt and retention of fees, commissions, or any monetary and non-monetary benefits from third parties other than qualifying "minor non-monetary benefits" (MNMBs). That prohibition is elaborated by implementing provisions which seek to identify acceptable MNMBs and a bespoke regime to allow portfolio managers to receive research without it constituting an inducement. MNMBs will be allowed provided that they are clearly disclosed, capable of enhancing the quality of service provided to the client, and cannot be judged to be of a scale and nature to impair compliance with a firm's duty to act in its clients' best interests. Under MiFID I, the provision of research was never treated as an inducement.

The MiFID II delegated directive states that research received from third parties shall not be regarded as an inducement for a portfolio manager if, in essence, the receipt of research does not create a pecuniary benefit to the portfolio manager because the research is received in return for either

- direct payments by the portfolio manager out of its own resources; or
- payments from a separate research payment account (RPA) controlled by the manager, provided that a range of conditions relating to that account are met.

Crucially, article 13(3) of the delegated directive suggests that it remains possible under MiFID II to collect the research charge alongside a transaction commission:

> *[T]he specific research charge shall. . .not be linked to the volume and/or value of transactions on behalf of the clients. . .Every operational arrangement for the collection of the client research charge, where it is not collected separately but alongside a transaction commission, shall indicate a separately identifiable research charge and fully comply with the conditions [relating to the operation of RPAs].*

This language suggests what is now generally accepted—that portfolio managers will be able to pay for both research and execution in a single transaction in basis points—provided that the separate costs of the two are clearly distinguished and the payment is not linked to the value/volume of transactions.

In order to operate an acceptable RPA model, the portfolio manager must ensure the following:

- The RPA can only be funded by a specific research charge to the client, which must not be linked to the volume/value of transactions executed on behalf of the client. It is clear that the charge may be paid for out of dealing commission provided that the research is priced separately ("unbundled").
- A research budget must be set, regularly assessed, and agreed upon with clients. Increases to the research budget may only take place after the provision of "clear information" to clients about such intended increases. The position under the delegated directive is more flexible than that proposed in the European Securities and Markets Authority's (ESMA's) Final Advice, which appeared to require a specific written agreement between the portfolio manager and its client for the initial budget and for any increase. If a surplus remains in the RPA at the end of a period, the portfolio manager is required to rebate that amount back to clients or offset it against future research costs.
- The quality of research purchased is regularly assessed based on robust quality criteria and its ability to contribute to better investment decisions.
- Clients and regulators are provided, upon request, with detailed information about the budgeted amount for research, research costs actually incurred, providers of research, amounts paid to such providers, benefits/services received from such providers, and any surplus.
- A written policy in respect of investment research is in place and provided to clients. The policy must cover (i) the extent to which research purchased through the RPA may benefit clients' portfolios including, where relevant, consideration of the investment strategies applicable to the various types of portfolios; and (ii) the "approach the firm will take to allocate such costs fairly to the various clients' portfolios."

The MiFID II delegated directive mandates national regulators to hold the portfolio managers they regulate that operate an RPA responsible for it. In relation to the requirement to allocate

costs fairly, one of the difficulties arising from "unbundling" is that research provided to the portfolio manager can benefit many clients of the firm, even if some of those clients do not agree to pay for the research or only agree to pay a small amount compared to others. Therefore, some clients could reap the benefits of research while leaving the burden of paying for it to other clients. It will be a challenge for managers to consider how best to allocate research costs fairly in such cases.

This may raise a quandary for US portfolio managers that have not needed to trace the indirect costs to clients (in the form of dealing commissions) to the benefits to those clients from research if such portfolio managers fit within the US Section 28(e) safe harbour.

However, where a portfolio manager collects the research charge alongside a transaction commission, the fee must indicate a separately identifiable research charge, and the manager must still use an RPA. Therefore, while article 13(3) appears to permit the continued usage of commission sharing arrangements (CSAs), the portfolio manager must estimate and disclose up front to its clients the research charges based on the relevant pre-set research budget, and the CSA will be subject to stringent assessment, transparency, and reporting obligations.

Additionally, to be compatible with the RPA requirements, existing CSAs will require amendment so that

- the charging structure upon which the CSA is based is aligned with the overall research budget the manager sets and periodically reviews;
- the charging structure associated with the CSA is expressly agreed upon with each client;
- the funds collected from the research charge are held in a separate RPA (if operating under a CSA, this would presumably be maintained with each broker with which the portfolio manager has entered into a CSA or an aggregator to which such balances are swept);
- brokers and other third-party research providers price and charge for the research they provide separately from any execution services; and
- any research charge paid to the broker under a CSA would be fully revocable so that it may be refunded if unused.

The detail around the exact form of an RPA and how it will interact with a CSA-style funding mechanism are yet to be determined by the industry. The Association for Financial Markets in Europe (AFME) is advocating that CSAs be renamed Research Payment Collection Agreements to reflect a new purpose as pools for the collection of research funds.

The new regime does not distinguish between equity research and fixed income research, which is a source of significant concern as the industry grapples with how the new regime will operate with fixed income (and other non-equity) research. FCA concedes that the regime in the context of fixed income research will be more challenging to operate, as fixed income research has historically been paid for out of the spread—meaning that there are no existing CSA structures to build upon. However, FCA is not prepared to carve out fixed income research from the regime.

It is feared that where portfolio managers opt to pay for research out of their own resources, there may be a resulting contraction in their research spend, as budgets shift from chief investment officers to finance directors. Where this ensues, negotiation over research spending may prompt questions about the frontier between negotiation and inducement.

Particular challenges are already arising for global portfolio managers and will continue to do so over the ensuing months until 3 January 2018.

Sell-Side Obligations

Specific obligations also apply to the sell-side under the delegated directive, particularly under article 13(9) which requires, in effect, that

- EU brokers identify separate charges for execution services that only reflect the cost of executing each transaction;
- any other benefits or services provided by the broker to the EU portfolio manager are subject to a separately identifiable charge; and
- the supply of such benefits and services and charges for them shall not be influenced or conditioned by the levels of payment for execution services.

Importantly, EU brokers will only need to price research separately when dealing with EU portfolio managers and will not need to provide such pricing information when providing research to US, Asian, and other non-EU portfolio managers. As clients of EU portfolio managers will soon be receiving information about research charges, it will be interesting to see if such clients start demanding the same from their non-EU portfolio managers.

The MNMB exemption

Research which constitutes an MNMB will neither be prohibited as an inducement nor subject to the bespoke research payment regime described above. The delegated directive gives some useful examples, including short term commentary on the latest economic strategies or company results, or third party written material that is commissioned and paid for by a corporate issuer to promote a new issuance.

It is worth noting that the portfolio manager may only receive MNMBs which are capable of enhancing the quality of service provided to the client in accordance with the standards governing that assessment under MiFID II.

Notably, once research is widely available, it may lose its materiality such that it is no longer subject to the regime in the first place, at which point the argument would be that the now-immaterial research constitutes an MNMB.

In summary, the options for compliance by portfolio managers with the new regime are the following:

- Pay "hard" for research out of profit and loss (P&L)—either by absorbing the costs of research or increasing headline fees;
- Use an RPA funded by one or more CSAs and therefore funded by an appropriate proportion of transaction commissions; or
- Have an RPA funded by a direct charge to clients.

Some fund management houses based in the United Kingdom have already announced that they will be paying for research "hard"—that is, out of P&L.
ESMA Q&A.

On 16 December 2016, ESMA issued a Questions and Answers document on MiFID II investor protection topics. The document provides responses about investor protection related questions posed by the general public, market participants, and regulators on the practical application of MiFID II.

One question posed in the Q&A is whether an EU money manager using an RPA can set the research budget for more than one client's portfolio when determining the group's research charge to a client and establishing the need for third party research. ESMA considers that a budget can be set for a group of client portfolios or accounts when the firm has established a similar need for third party research in respect of the investment services rendered to its clients. This will allow firms to set a research budget at a desk or investment strategy level, for example, if the client portfolios have sufficiently similar mandates and investment objectives such that investment decisions relating to these portfolios are informed by the same research inputs.

Those EU investment firms that take research provided by a group entity will have taken note of ESMA's view that the MiFID II regime applies in the same manner irrespective of being part of the same group or not. In particular, ESMA specifies that where firms do seek to receive third party research from or provide it to other group entities using an RPA model, the requirement on the EU portfolio manager to ensure a research budget is used and

managed in the best interests of clients and that the costs of research are allocated fairly between client portfolios "will be particularly important". ESMA comments somewhat ominously: "The commercial preference of a firm to operate as part of a global business model does not override their obligations under Article 13 if using an RPA." This foreshadows but by no means delineates what will be a growing challenge for global firms.

ESMA also answers the question of whether EU portfolio managers can accept research from third country providers that are not subject to MiFID II requirements to the effect that they must comply with the MiFID II regime irrespective of the status or geographical location of the research provider.

FCA Implementation of new regime in UK

FCA published its third consultation paper on implementing MiFID II in September 2016 and addressed the new research for payment regime therein. Whilst a detailed treatment of FCA proposals for implementation is beyond the scope of this *LawFlash*, it is worth noting that FCA has proposed to apply the MiFID II regime to firms which are not subject to MiFID II, including, namely, the following:

- Undertaking for Collective Investment in Transferable Securities (UCITS) management companies
- Full-scope UK Alternative Investment Fund Managers (AIFMs)
- Small authorised AIFMs and residual collective investment scheme operators
- Incoming European Economic Area (EEA) AIFM branches

FCA's proposed policy here is to apply the same standards to all forms of investment management activity notwithstanding the lack of a mandate to do so in the UCITS Directive or AIFMD. By doing so, FCA is "gold-plating"—and has received pushback from concerned consultees. If other EU regulators decline to follow suit, the United Kingdom will have put itself at a competitive disadvantage.

The consultation period for the September 2016 consultation paper closed on 31 October 2016. FCA continues its thorough consultative process, publishing its fifth consultation paper on 31 March 2017 for which the consultation ends on 12 May or 23 June 2017, depending on the topics under consultation. On timing, FCA plans to finalise changes to its Handbook to implement MiFID II in H117 with the publication of two policy statements announcing FCA's response to the consultation, its final policy decisions, and changes to the Handbook. The first policy statement was published on 31 March, and the second is scheduled for June 2017; payment for research will be addressed in the second statement.

Global Impact

MiFID II's requirement that payments for research be unbundled from commissions has raised questions about potential global implications because of cross-border dealings by both global portfolio managers and global broker-dealers. For example, under US law, the receipt of "hard dollar" payments for research—whether through an RPA or out of a portfolio manager's own funds—might cause US broker-dealers to be deemed "investment advisers" subject to the Investment Advisers Act of 1940 (Advisers Act). This is because the Advisers Act defines "investment adviser" broadly to include any person who, for compensation, engages in the business of providing advice about securities.

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Broker-dealers are now able to operate their research businesses without being deemed investment advisers because of a narrow exclusion for broker-dealers in the Advisers Act. Under this exclusion, a broker-dealer is not an investment adviser if (1) the investment advice it provides, such as research, is "solely incidental" to its brokerage business and (2) the broker-dealer does not receive "special compensation" for the advice. Broker-dealers are able to rely on the exclusion by providing research as part of their brokerage business and being paid through traditional brokerage commissions. A broker-dealer's receipt of hard dollar payments for research might raise questions about whether the broker-dealer has received special compensation and therefore whether it can rely on the broker-dealer exclusion.

Under US law, broker-dealers are subject to comprehensive regulation that addresses conflicts of interest and other issues in preparing and distributing research, including Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 and Regulation AC thereunder, as well as Financial Industry Regulatory Authority (FINRA) rules, such as FINRA Rules 2241 (Research Analysts and Research Reports), 2242 (Debt Research Analysts and Debt Research Reports), and 5280 (Trading Ahead of Research Reports). Being deemed an investment adviser would overlay another regulatory regime—the Advisers Act—on top of this.

A significant concern with being subject to the Advisers Act is that it would create a fiduciary relationship between a US broker and its research customers. Another is that investment adviser status would subject research brokers to Section 206(3) of the Advisers Act, which prohibits principal trading unless an investment adviser can meet onerous trade-by-trade written disclosure and consent requirements. In a research relationship, a broker might have difficulty meeting those requirements because the broker could not know when an investment manager is trading with the broker based on research the broker provided. Impeding a broker's ability to trade with portfolio managers and their clients on a principal basis would impact the broker's ability to provide capital commitment, provide "natural liquidity", make available offerings for which a broker is an underwriter, or step in between parties as a "riskless principal" to preserve the anonymity of trading parties—all critical roles played by brokers.

The new research payments regime in the European Union will also have global implications to the extent that EU regulators, including FCA, take an expansive view on how the new research payment regime applies in a cross-border context (for example, in the context of outsourcing, delegation, sub-advisory, or other arrangements) or where global asset management firms strive to implement similar or the same policies across affiliates for more administrative ease and to ensure fair treatment for all clients. Either possibility will complicate efforts to "ring fence" the effects of the new research payment regime to European dealings and raise the specter of a clash between and among regulatory regimes globally.

Regulators on both sides of the Atlantic need to strive to avoid the potential for European portfolio managers becoming barred from accessing US-produced research, engaging with US-based analysts, or accessing the US capital markets, or for US broker-dealers being impeded in their ability to compete in European capital markets because of the incongruence of EU and US law that may restrict their ability to both provide research and trade with portfolio managers and their clients. **THFJ**