Measuring your approach
MiFID II and payments for investment research

December 2016
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1. **Background**

1.1 When MiFID II is due to take effect on January 3, 2018, investment firms will not be able to accept investment research as form of non-monetary benefit, unless:

- it passes the Quality Enhancement Test ("QET") and is classified as a Minor Non-Monetary Benefit ("MNNB")
- it is paid for out of its own resources
- it is paid by the client and the firm meets the requirements in sections 3 to 8 below

1.2 This note does not address the QET or MNNB.

2. **FCA Implementation**

In its third MiFID II implementation Consultation Paper, CP 16/29, the FCA has proposed a new section 2.3B in the Conduct of Business Source book. The FCA proposes to define “research” to capture research material or services:

(1) concerning one or several financial instruments or other assets

(2) concerning the issuers or potential issuers of financial instruments

(3) closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector And which explicitly or implicitly recommends or suggests an investment strategy and provides a substantiated opinion as to the present or future value or price of such instruments or assets, or otherwise contains analysis and original insights and reaches conclusions based on new or existing information that could be used to inform an investment strategy and be relevant and capable of adding value to the firm’s decisions on behalf of clients being charged for that research.

3. **Scope and territorial application**

3.1 The FCA has drafted the proposed rules on inducements in a way that will impose a ban on any firm that receives a non-monetary benefit when providing the services of investment advice or portfolio management, unless the obligations in the proposed COBS 2.3B are met.

There is an implicit assumption in the rules that research is an inducement that may cause the firm to act other than in the best interests of the client.

Our view is that these rules apply at a “firm level” (our terminology). We have structured this section in a question and answer format to explain how we have arrived at this conclusion.

**Question:** When an UK investment firm delegates portfolio management to a third country firm, i.e. one outside the European Economic Area (“EEA”), should receipt of research by that third country firm be considered as a benefit received by the UK investment firm?

**Answer:** Our view is that it should not. If the third country firm does not share the research with the UK investment firm, it is difficult to see how there would be a direct benefit to the UK investment firm.

**Question:** How should we consider our overarching obligation to act in in the best interests of the client?

**Answer:** It is clear that the FCA considers that there is potential client detriment when investment firms or third country firms receive non-monetary benefits which fail to satisfy the QFT and MNNR requirements. Therefore, UK investment firms that do not require their third party managers to comply with COBS 2.3B will need to consider including additional disclosures within the relevant investment management agreement or other delegation agreement. In addition, investment firms will need consider, particularly for retail clients, whether their third country investment managers have sufficient controls in place to ensure that explicit trading costs, such as commissions/spreads, are minimised such that any non-monetary benefits received are proportionate to these costs.
**Question:** Should we use the same methodology when considering the scope of the best execution obligation?

**Answer:** No. The reason for this is that the best execution obligation applies at the “client level” (our terminology) as investment firms are required to take all sufficient steps to obtain the best possible result for their clients.

4. **Setting the research budget**

4.1 An investment firm will need to set a Research Budget, this could be one large budget or lots of small budgets per desk that are then aggregated together to form a larger budget. The budget could be set over any time period and this is at the discretion of the firm.

4.2 It will need to establish a policy for setting the Research Budget and this will need to be based on the need for third party research in respect of the “investment services rendered to its clients.”

4.3 We take this to mean that the budget should be built from a bottom up assessment of the value of research received and how it helps the firm serve its clients. It shouldn’t be based on trade volumes, but could be partially based on assets under management.

4.4 The Research Budget will need to set the overall amount that will be paid for research in addition to what types of research will be received in return. This means that the firm will need to keep an inventory or the research received.

4.5 We would also expect that the compilation of an initial budget will require the firm to:

- create an inventory of research received over the past year (or perhaps a shorter time, if this is representative)
- assess the cost and quality of that research
- evaluate whether the firm received value for money
- use the cost of research previously for setting a forward looking budget with adjustments for value for money and expected business changes

4.6 The firm will need to provide a policy to clients in relation to how it assesses the quality of research. This policy also needs to set out the criteria used to assess quality and in particular demonstrate how the research received contributes to “better investment decisions.”

4.7 The Research Budget is an internal administrative measure. However, increases in the budget should “only take place after the provision of clear information to clients about such increases.”

The total of all Client Research Charges (see section 5) cannot be higher than the Research Budget.

5. **Agreeing the Client Research Charges**

5.1 A firm will have to pay for research (in whatever form) from a Research Payment Account (“RPA”). Our initial view is that the RPA as an “account” could be viewed as either:

- a notional pot of money (i.e. an accounting mechanism or other recordkeeping system) rather than a physical bank account (our preference)
- an account (or series of accounts) which the firm controls

5.2 A firm will have to fund the RPA (credited, to use terminology similar to a corporate bank account) via a Client Research Charge (“CRC”). A CRC is a nominal charge that can be set over any period determined by the firm.

5.3 The client will then need to pay the CRC, either directly on an invoiced basis or collected alongside transactions.

5.4 The firm should base the CRC on the research budget. This means that there should be an equitable mechanism for allocating the Research Budget between different clients. MiFID II requires that the Client Research Charge “not be linked to the volume and/or value of transactions executed on behalf of clients.” However, MiFID II is silent on whether the charge can be based on assets under management, adjusted for inflows and outflows.
5.5 The total of all CRCs cannot be higher than the Research Budget.

5.6 The firm will have to pay for research from the RPA as MiFID II requires “payments from a separate research payment account.” It is unclear, however, whether this will require notional or actual payments.

5.7 Clients will need to approve the size of the CRC, its frequency and the mechanism for increasing the charge.

5.8 If there is a surplus in the RPA at the end of the period, the firm will require a process to rebate the Client Research Charge or, if agreed by the client, carry it over to the next period.

6. Operating the RPA

6.1 The CRCs will act to credit the RPA and Research Payments will act to debit the account.

6.2 The firm will need to control the operation of the RPA but can be permitted to delegate the day-to-day operation to third parties. The RPA will need always to have a nil or positive balance and without further guidance our initial view is that a firm could operate the RPA on the following basis:

- if the client agrees to pay a CRC of £100k for the first quarter of the year, then the Research Payment Account should be credited with £100k on January 1. The client should make the payment on demand at a later date (if invoiced) or over the course of the quarter if collected via commissions alongside transactions. Recognising the CRC when paid or collected via commissions would appear to be overly complex and not a specific regulatory requirement, however there will need to be some reconciliation between the amount charged and the amount paid

- the RPA should be debited when amounts are paid from CSA’s or directed brokerage

6.3 The administrative mechanics around the RPA will be complex and there would be robust governance arrangements around the operation of the account which includes an “audit trail of payments made to research providers and how the amounts paid were determined within reference to the quality criteria”. This implies that prior to payments for research there would need to be some sign-off mechanism to check that the payments are only in relation to research which meets certain predetermined criteria.

6.4 We are making the assumption that the RPA is only a nominal account, however if the Commission, ESMA or the FCA require a physical cash account with “upfront” payment this will require additional consideration as to whether, for example, obligations arise under the FCA Client Money Rules. The FCA have indicated in the draft COBS 2.3 that the Mandate Rules will apply suggesting that firms will not have to treat the RPA as a Client Money account.

7. Assessing the quality of research

7.1 The firm should “regularly assess the quality of research purchased based on robust quality criteria and its ability to contribute to better investment decisions”. This means that there needs to be some mechanism to review the research received and check that it meets the quality criteria set out in the policy.

7.2 Firms are required to establish these elements in a written policy and provide it to clients. The policy should also address the approach the firm will take to allocate costs fairly to various clients’ portfolios.

7.3

8. Keeping records of payments and client disclosures

8.1 Clients and regulatory authorities will have the ability to request a summary of the providers paid from the RPA, the total amount they were paid over the period and the benefits and services received by the investment firm and how the total amount spent from the research payment account compares to the budget set by the firm, noting any rebate or carry-over if residual funds remain in the account.
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Appendix A: a graphical illustration of Article 13

(article references have been inserted alongside boxes)
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Broker A

Broker B

Independent research house A

Research charges cannot exceed research budget (4)

Research Budget

Assess research quality (1(b)iv)

Arranging the research budget (1(b)ii)(2),(6)

Research quality policy (8)
Appendix B: Article 13 of the MiFID II Delegated Directive, Inducements in relation to research

1. Member States shall ensure that the provision of research by third parties to investment firms providing portfolio management or other investment or ancillary services to clients shall not be regarded as an inducement if it is received in return for any of the following:

(a) direct payments by the investment firm out of its own resources

(b) payments from a separate research payment account controlled by the investment firm, provided the following conditions relating to the operation of the account are met:

(i) the research payment account is funded by a specific research charge to the client
(ii) as part of establishing a research payment account and agreeing the research charge with their clients, investment firms set and regularly assess a research budget as an internal administrative measure
(iii) the investment firm is held responsible for the research payment account
(iv) the investment firm regularly assesses the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions

(c) where an investment firm makes use of the research payment account, it shall provide the following information to clients:

(i) before the provision of an investment service to clients, information about the budgeted amount for research and the amount of the estimated research charge for each of them
(ii) annual information on the total costs that each of them has incurred for third party research

2. Where an investment firm operates a research payment account, Member States shall ensure that the investment firm shall also be required, upon request by their clients or by competent authorities, to provide a summary of the providers paid from this account, the total amount they were paid over a defined period, the benefits and services received by the investment firm, and how the total amount spent from the account compares to the budget set by the firm for that period, noting any rebate or carry-over if residual funds remain in the account. For the purposes of point (b)(i) of paragraph 1, the specific research charge shall:

(a) only be based on a research budget set by the investment firm for the purpose of establishing the need for third party research in respect of investment services rendered to its clients
(b) not be linked to the volume and/or value of transactions executed on behalf of the clients

3. 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 in paragraph 1, points (b) and (c).

4. The total amount of research charges received may not exceed the research budget.

5. The investment firm shall agree with clients, in the firm’s investment management agreement or general terms of business, the research charge as budgeted by the firm and the frequency with which the specific research charge will be deducted from the resources of the client over the year. Increases in the research budget shall only take place after the provision of clear information to clients about such intended
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increases. If there is a surplus in the research payment account at the end of a period, the firm should have a process to rebate those funds to the client or to offset it against the research budget and charge calculated for the following period.

6. For the purposes of point (b)(ii) of paragraph 1, the research budget shall be managed solely by the investment firm and is based on a reasonable assessment of the need for third party research. The allocation of the research budget to purchase third party research shall be subject to appropriate controls and senior management oversight to ensure it is managed and used in the best interests of the firm’s clients. Those controls include a clear audit trail of payments made to research providers and how the amounts paid were determined with reference to the quality criteria referred to in paragraph 1 (b) (iv). Investment firms shall not use the research budget and research payment account to fund internal research.

7. For the purposes of point (b)(iii) of paragraph 1, the investment firm may delegate the administration of the research payment account to a third party, provided that the arrangement facilitates the purchase of third party research and payments to research providers in the name of the investment firm without any undue delay in accordance with the investment firm’s instruction.

8. For the purposes of point (b) (iv) of paragraph 1, investment firms shall establish all necessary elements in a written policy and provide it to their clients. It shall also address the extent to which research purchased through the research payment account may benefit clients’ portfolios, including, where relevant, by taking into account investment strategies applicable to various types of portfolios, and the approach the firm will take to allocate such costs fairly to the various clients’ portfolios.

9. An investment firm providing execution services shall identify separate charges for these services that only reflect the cost of executing the transaction. The provision of each other benefit or service by the same investment firm to investment firms, established in the Union shall be subject to a separately identifiable charge; the supply of and charges for those benefits or services shall not be influenced or conditioned by levels of payment for execution services.
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