MiFID II, PAYMENTS FOR RESEARCH: UNBUNDLING THE CONFUSION

Summary: This briefing charts the history of the debate over payments for research in the UK and notes that regulatory proposals to unbundle payment for execution from payment for research are not new. In the face of industry opposition, the FCA's (and the FSA's before it) approach has been an evolutionary one characterised by a progressive tightening of the rules.

Emboldened by ESMA's Consultation Paper of May last year, the FCA released a Discussion Paper supporting ESMA's position. It remains to be seen whether, in light of the softening of ESMA's stance in its most recent papers, the FCA will maintain its view. In any event, ESMA's latest proposals in this area, if implemented, would pose a number of difficult issues for firms, some of which we touch on.

THE UK APPROACH TO THIS AREA HAS BEEN CHARACTERISED BY PROGRESSIVE TIGHTENING

Since the time of the "big bang" in 1986 and the end of fixed commission arrangements in the UK, the purposes for which client commission generated through trading can be used have been progressively narrowed. This has involved weighing the need for the UK asset management industry to compete internationally with regulatory concerns that an overly permissive regime might encourage inefficient routing of client orders, over-consumption of research and over-trading, none of which is in the best interests of clients.

Unbundling the payment for research from payment for execution is one possible way to address these potential conflicts and such proposals are not new in the UK. Indeed, following the Myners review in 2001, the FSA proposed[1] a rebate of research payments to the customer which would have resulted in a de facto unbundling. However, in the face of strong industry protest and concerns about the competitiveness of the UK asset management industry, the FSA backed away from this position. Instead, in March 2005, new rules were introduced which imposed more rigorous and extensive client disclosure requirements, together with a narrowing of the scope of services that were permissible to be paid for out of client commissions.

One frequently utilised method of paying for research in the UK has been through the use of Commission Sharing Agreements (CSAs). Under a typical CSA, the broker retains the portion of commission attributable to execution and holds the balance to the client's order. This balance pays for external research and other services selected by the manager.

Commonly, commission attributable to research is allocated on the basis of a "broker vote" carried out by the manager. This methodology has been criticised by the FCA on the basis that by linking trading activity to research needs and budgets, it could incentivise managers to over-trade in order to acquire more votes and therefore a greater share of the research budget. Further, since votes were often assigned a percentage (rather than monetary) value, the FCA believes that managers were not encouraged to consider whether they were receiving value for money.

In light of these concerns, the FCA recently[2] proposed a further tightening of the rules, primarily by introducing more evidential criteria to establish whether research was "substantive" and to reiterate that "corporate access" was outside the scope of permitted services. However, this evolutionary approach that had characterised the UK's attempts to date was called into question by progress on MiFID II.

MiFID II APPEARED TO INTRODUCE AN OUTRIGHT BAN BUT THE POSITION HAS SOFTENED

MiFID II distinguishes between the rules that apply to the provision of (i) independent investment advice and portfolio management (Article 24(7)(b) and Article 24(8)) and (ii) investment services more generally (Article 24(9)). In both cases, an investment firm is prevented from accepting and retaining fees, commissions or non-monetary benefits paid or provided by any third party in relation to the provision of the service to clients.

However, in the case of portfolio management, Article 24(8) of the Directive[3] provides a carve-out for "minor non-monetary benefits":

> *"Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair confidence with the investment firm's duty to act in the best interest of the client should be clearly disclosed and are excluded from this paragraph."*

Clearly, much depends on what is meant by "minor non-monetary benefits" in this context. In its Consultation Paper from 22 May 2014, ESMA (operating on the basis that research could act as an inducement) proposed that this phrase should be narrowly construed so that only generic, widely-distributed research could be considered to fall within this definition. This was the direct opposite to the approach the FCA had taken in its Policy Statement 14/7 published earlier in that month, with its focus on permitting client funding of "substantive" research only.

[1] See the FSA's Consultation Paper 176 (CP 176)
[2] See the FCA's Policy Statement 14/7 (PS 14/7)
[3] Directive 2014/65/EU

ESMA's original proposal met with considerable opposition from the industry. Arguments were made that the proposal disadvantaged smaller investment managers and would result in some clients missing out on the benefits of important/value-adding insights that improve their returns. It could also lead to misallocation of capital since research providers might choose not to cover smaller, less significant companies.

In response to this opposition, ESMA's subsequent proposals released on 19 December 2014 are less restrictive. Payment for research "hard" (i.e. out of the manager's own funds) is still clearly envisaged but in addition a new separate pre-funded "research payment account" is now contemplated.

Under the new proposal, research budgets must be set in advance by the manager. The account would be funded by clients and payments from the account must not be linked to the volume of transactions executed. ESMA supports the introduction of high level provisions requiring brokers to price research and execution services separately. If any surplus remains in the research payment account, it must either be rebated to clients or offset against future research costs. Managers must regularly assess the quality of the research they receive and brokers must charge for execution and research separately. Further, the charge for research must not be influenced by the volume of execution services provided. In this way, ESMA hopes to address many of the key criticisms of the existing regime while stopping short of an outright ban on client payment for research.

SIGNIFICANT AREAS OF UNCERTAINTY FOR FIRMS REMAIN FOR FIRMS

The softening of ESMA's stance has resulted in the industry breathing a collective sigh of relief. However, a number of important areas of uncertainty and practical considerations remain unresolved. Some of these include:

- ***Level playing field***: As was the case with the FSA's proposals in the early 2000s, much criticism of ESMA's original position was focused on the competitive disadvantage European portfolio managers would face, both internationally and within Europe. In particular, EU fund managers that are subject to the AIFMD or the UCITS Directive are outside the scope of these proposals, while US investment managers are free to operate as they always did.

  While ESMA's softened stance has improved the position somewhat, these concerns remain. ESMA has committed to asking the Commission to align the requirements of the AIFMD and the UCITS Directive with the final position under MiFID. Nevertheless this will take time and could still have an impact on the industry in the interim. The FCA has said that it will try to ensure a level playing field but it is unclear how this will be achieved and whether it will be possible without action at European level.

  Many international investment firms employ models under which managers manage the money of investors from several legal entities. Some of those entities may be subject to the EU requirements and some may not. This will create significant operational issues when it comes to paying for research received by those managers.

- ***Renegotiation of existing CSAs***: Investment managers and brokers who already have CSAs in place will have a head start vis-à-vis those firms which will need to draw up agreements from scratch. Nevertheless, even these firms will need to revisit the terms of their existing CSAs to amend them in light of the finalised proposals. It is too early to start this process now as much of the fine detail is yet to be decided but, depending on the size of the manager and the number of executing brokers it uses, this could be a considerable and resource intensive undertaking. The Investment Association has announced that it will begin work on an industry standard document that firms can use for these purposes; however firms will need to ensure that it is workable from a practical perspective. Sufficient time must be allowed to ensure that firms are operationally ready for the introduction of the new regime.

- ***Analysis of the impact on debt markets***: The application of these restrictions to debt markets will be entirely new and investment managers will need to think carefully about how these new proposals will affect their trading in this area. How will they ensure they continue to receive the research they need and pay for it?

- ***Difficulty of valuing research***: The value of research is inherently subjective and depends on many factors. This will make it difficult for both brokers to price research and for managers to compile research budgets and to discharge their obligation to ensure that they are receiving value for money. How will value be measured? What evidence will need to be retained to substantiate a manager's decisions in this area?

- ***Quality and scope of research may decline***: There is also a concern that the quality of research will decrease as its price becomes more transparent and therefore important. The drive to minimise costs is likely to result in a rationalisation of the research market, with fewer providers and fewer securities being covered. This could result in less efficient allocation of capital and reduced liquidity for securities issued by smaller cap companies.

- ***Client money concerns***: There are some question marks over the status of any funds held within the research payment account. Whether money held in the research payment account will qualify as client money is a policy decision for the authorities. If this is classified as client money, how will that affect managers who do not have permission to hold or control client money? It is possible that some of these concerns could be addressed through the use of third party firms who will administer the accounts.

- ***The FCA's attitude***: Following the release of ESMA's May Consultation Paper, the FCA made clear in its Discussion Paper released on 10 July 2014 (DP14/3) that it fully supported ESMA's efforts to unbundle payment for research from payment for execution and, to its mind, the only question was whether ESMA's proposals at that time went far enough or whether payment for any form of research from client commissions should be prohibited.

  It appears, therefore, that the FCA is philosophically persuaded of the case for full unbundling and it remains to be seen whether the FCA will maintain this stance in light of ESMA's latest pronouncements.

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