THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

APPROACH TO RESEARCH UNDER MIFID II

INTRODUCTION:

The Investment Association (IA) represents UK investment managers. It has over 200 members who manage more than GBP 5.5 trillion for clients around the world, helping them to achieve their financial goals. The IA's aim is to make investment better for clients, companies and the economy.

The IA does not advocate or support any particular approach to research, rather the purpose of this paper is to review the regulatory obligations and constraints of the prospective options faced by investment managers in transitioning to MiFID II. To the extent the paper suggests approaches that seek to meet the requirements of the MiFID II regime, they are not intended to be exhaustive and other different approaches and arrangements may also meet the requirements. This paper does not constitute advice and the IA accepts no liability for any consequent loss. Firms should take independent legal advice to reflect their specific circumstances.

REGULATORY BACKDROP:

MiFID II brings substantial change to the regulation of research.

Inducements rules within the Directive prohibit investment firms that provide investment advice and portfolio management from receiving non-monetary benefits (unless they are minor[1]). The Delegated Act applies this prohibition to investment research, requiring research to be paid for separately from execution and specifying detailed conditions under which such payments can be made. Recital 28 gives further detail on what is regarded as research in the new MiFID II world:

'Research in this context should be understood as covering material or services concerning one or several financial instruments…… and provides a substantiated opinion as to the present or future value or price of such instruments.'

Investment managers should be aware that apart from a small number of explicit exemptions, these provisions apply to all forms of equity and non-equity research[2], including written

[1] Delegated Directive Article 12(2) & (3).

[2] Note: MiFID II extends the definition of foreign exchange derivative to include anything that settles on a longer than T+2 basis.

research, analyst calls and meetings. National Competent Authorities (NCA's) now have until 3 July 2017 to transpose the rules, which will subsequently apply to firms from 3 January 2018.

In the new world, investment managers purchasing research must incorporate the requirements principally but not limited to Article 13 of the Delegated Directive, (MiFID level II) . Investment managers should note that as these provisions sit within a Delegated Directive, it is open to the Financial Conduct Authority (FCA) to interpret and potentially gold plate in the handbook for UK application.

Notwithstanding that these provisions sit within a Delegated Directive, the IA would encourage the FCA and other EU Member State regulators to take a harmonised approach to the implementation of the new research rules that takes into account compatibility with other major financial centres.

The key new requirements under MiFID II in relation to research for market participants are:

- The setting and assessment of research budgets.
- Client[3] agreement of the research budget.
- Regular assessment of the quality of research and its ability to contribute to the investment process.
- Enhanced disclosure of information to clients on the costs of research.
- Written policies outlining the approach to research including how the firm will allocate costs fairly to clients' portfolios.
- Brokers to establish separate charges for research and execution.

Investment managers face the challenge of implementing MiFID II within a wider international context. As a leading global centre for asset management, firms must find an interpretation which works not just in the UK but within global structures for clients and counterparties across the EU and outside it. Many investment managers will have Portfolio Managers (PMs) spread out across non-EU jurisdictions as well as global order routing processes to incorporate into the new regime. Firms must have an approach that works for their global model and deals with any potentially differential implementation across EU Member States.

[3] For the purposes of this analysis, the term client is used as defined in MiFID II "Client" under Article 4(1)(9) as meaning any "natural or legal person to whom an investment firm provides investment or ancillary services"**. In this scenario, the investment manager's client is the governing authority of the fund itself, (the fund manager) and not the fund's underlying clients (the unit holders)**. Therefore, any agreement that is required under Article 13 of the Delegated Directive is required to be between the investment manager and the fund manager; and does not require the agreement of the fund investors. If any other interpretation is taken, this would impose an unworkable administrative burden for investment managers. **For segregated mandates, the client is the legal entity to whom the investment services are provided, generally the asset owner.**

Following the Brexit vote on 23 June 2016 members should start from the position that MiFID II will be implemented in full in the UK. Unless and until the UK exits the EU, investment firms will continue to have the same access and obligations in the single market as they do today.

On 24 June 2016 the Financial Conduct Authority (FCA) publicly stated that:

"Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect."

More detailed analysis on this issue is available in the specific Brexit papers available on the IA website.

FUTURE RESEARCH MODELS:

This paper covers the three potential future research models under MiFID II:

Model 1: Direct payment for research out of the firm's own resources (P&L).

Model 2: Make a direct charge to the client to fund a Research Payment Account (RPA).

Model 3: Make a charge to the client that is collected alongside transaction commissions to fund an RPA.

The paper is structured with **requirements laid out in a cumulative fashion**. Each model will have to comply with regulatory obligations and constraints. **The issues which are outlined in the section for Model 1 also apply to Models 2 & 3**. The requirements outlined in the Model 2 & 3 sections only apply to Models 2 & 3. Therefore, the paper is structured to demonstrate the progressive application of obligations when using an RPA.

Whichever route firms decide to go down (including model 1 - P&L) they will face a series of issues that they will have to tackle in the run up to implementation of MiFID II, in particular:

1. Budgeting and allocation of research costs in the best interests of clients.
2. Acquisition of fixed income research.
3. Paying US brokers who offer research alongside execution.
4. New pricing models from the sell side that will need to be negotiated.
5. Global structures and international clients.
6. The mechanisms required to transition to one of the three options in the new regime.
7. Application of VAT.

Those firms choosing model 2 (a direct charge to clients) will also have to, in addition to those above, deal with issues around:

1. Assessing the quality of research based on robust quality criteria and its ability to inform investment decisions for clients.

2. Disclosure to clients (pre execution and periodic).

3. The legal status of monies held in Research Payment Accounts.

4. Where not all clients are paying the research charge.

5. Timing of payments and collections from clients.

6. Client research charge methodology.

Investment managers opting for model 3 (alongside transaction commissions) will have to deal with further complexity around:

1. Allocating costs to clients.

2. Conflicts of interest between clients.

3. Structuring and operation of RPAs.

4. Treatment of aggregated trades.

A. MODEL 1: DIRECT PAYMENT OUT OF THE FIRM'S OWN RESOURCES

Using the firm's own P&L (model 1) to purchase research removes many of the regulatory obligations concerning research selection and client reporting, but does not result in a completely free hand. The requirements in section A apply to all three models.

Separately, many of the other MiFID II provisions overlap with the specific RPA requirements. Clearly firms will still also have to abide by the enhanced best execution, conflicts and inducements provisions in MiFID II and ensure they act in the best interests of their clients. Even without Article 13, this triumvirate of rules creates a challenging framework.

However, moving to P&L shifts many of the key questions away from a regulatory space to an internal business context and / or a commercial discussion between firms and their counterparties.

A.1 BUDGETING:

Whilst firms will already have robust budgeting processes in place, these will need enhancements to meet the new regulations.

The appropriate level of research spend for firms will need to be considered regardless of payment method. Investment managers will not be able to receive research without payment of their own resources or out of an RPA funded by the client. This is likely to result in a review of existing research received and its value to the firm. Investment managers should not underestimate the potential size of such an exercise. In any case, for investment managers operating model 2 or 3 (operating an RPA) the Directive requires that firms set a research budget and regularly assess it as an internal control measure.

In addition, until the new pricing models from brokers become available, firms can answer the *'what do we need?'* question internally, but not the flip side of the coin the *'how much does it cost?'* question. There will be a significant negotiation process with the sell side and investment managers will need their own valuation models to participate in this.

In moving to a P&L model, the source of funds for research shifts. This could imply a shift of control over that budget. Currently the research budget will often be controlled by the Chief Investment Officer (CIO). In a P&L model, there might be greater involvement from the Chief Financial Officer (CFO) or Chief Operating Officer (COO).

KEY QUESTIONS:

- Size of research budget?
- How is it allocated within the firm?
- Who controls the budget?
- At what level of granularity should the budget be?

A.2 ACQUISITION OF FIXED INCOME AND NON-EQUITIES RESEARCH:

To the extent that investment managers are receiving non-equities research that falls within the MiFID II definition and does not constitute a minor non-monetary benefit, fixed income may become an issue irrespective of the chosen model. A solution needs to be found for fixed income research and any other non-equity asset classes where research is being used.

Unlike for equities, in the current MiFID I environment, there is generally no separate payment for fixed income research. Under MiFID II, Article 13(9) brokers will be required to separately charge for research where it is provided alongside execution. This will disrupt the current charging model, as irrespective of asset class there must be a separately identifiable charge for each service provided:

'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'

Brokers will also not be able to distinguish between clients who are RPA and those which are P&L when executing fixed income transactions.

For example: A broker is offering the same spreads to investment manager A (Model 3: RPA) and investment manager B (Model 1: P&L) for a fixed income execution.

Investment manager A (Model 3: RPA) is paying the broker separately for fixed income research.

The broker cannot then say that research to investment manager B (Model 1: P&L) is paid for 'through the spread', as this would be considered an inducement.

Therefore even if investment managers choose a P&L model to pay for research they may still be impacted by the disruptive effect of the legislation on the wider market. As a result, firms must now consider how to make direct payment to brokers for their fixed income research.

Although the industry is likely to devise many different approaches, one possible model is for brokers to move to a chargeable time basis for their research analysts. Brokers would track who their analysts are speaking to and for how long. Investment managers would then need to overlay a value judgement on any such interactions. This would require system enhancements on both sides to ensure the accuracy required. We consider that a valuation model is likely to be required by the investment manager irrespective of asset type, although the use of sell side research is generally less in the fixed income asset class.

Recital 29 outlines a number of exceptions to the research requirements that can be deemed minor non-monetary benefits and which, given the nature of the fixed income markets, may apply to certain materials received from fixed income broker-dealers:

- Research paid for by a corporate third party to support a new issuance or potential new issuance.
- Research paid for by a corporate third party on an ongoing basis.
  (Any corporate funded research must be disclosed and openly available).
- Short term market commentary.
- Non-substantive opinion on macro-economic, market or company data.

Investment managers will need to have policies and procedures in place to make their own assessment of what is formally research. The IA considers that non-substantive *sales notes, market colour* or high level *macro-economic commentary* would not be covered by the new Article 13 definition of research and other types of material may also fall within the exemption. These can be received by the investment manager without charge and would not be an inducement.

However firms should have in place their own systems & controls to assess what they are receiving in this category. For example, the sell side badging a document as a sales note does not in and of itself, automatically move it out of the formal recital definition of *research.* It is for investment managers to assess themselves whether any benefit is minor in nature and scale.

A.3 US BROKERS:

There is significant complexity across the global research market with interconnected and sometimes contradictory nature of regulations in different jurisdictions. MiFID II creates a particular issue for investment managers sourcing research from US brokers.

Under the SEC Securities Exchange Act section 206(3), US brokers cannot receive direct payment for research unless they register as an Investment Advisor in the US. Section 28(e) of the act provides a safe harbour to money managers who use the commission dollars of their advised accounts to obtain investment research and brokerage services, provided that certain conditions are met. Registering as an Investment Adviser is potentially unattractive to brokers as among other obligations, it places restrictions on their ability to trade on a principal basis.

There are many different permutations of this issue: for example where an EU (MiFID) investment manager delegates management to a US investment manager, the US investment manager itself is not obliged to comply with MiFID II while receiving research from a US-only broker. How such a situation would fit into FCA rules has been raised previously by the IA[4]. The purchase of research and more widely the activity of investment management are global in nature. We would welcome clarification from FCA on the jurisdictional reach of COBS and in particular its interaction with the US regime.

For those US brokers who have an EU presence, it may be that new contractual arrangements can be put in place to route all research for European clients through their European entity. This would allow firms who are going P&L to pay brokers directly. A parallel example of a regulatory solution to this issue is the FINRA rule filing[5], which contemplates that firms can use their non-US broker-dealer affiliate to send global research to non-US clients and avoid the US rules on research. Alternative options are to seek SEC no-action relief in respect of the 206(3) prohibition.

A.4 NEW PRICING MODELS FROM THE SELL SIDE:

In considering this issue, investment managers will need to take into account that the charging landscape for research will change from current models. Recital 26 of the Delegated

[4] See the IA response to FCA CP13/17.

[5] Securities and Exchange Commission (Release No. 34-77963; File No. SR-FINRA-2016-017) June 1, 2016

Directive requires that brokers must charge for, and supply research & execution separately. Recital 30 builds on this by stating that a broker allocating *valuable resources* to an investment manager cannot be considered a minor non-monetary benefit. The implication is that brokers cannot price their research services at zero. Receiving research in such a manner would be considered an inducement. As such the buy side will have to put in place a methodology to review pricing, i.e. comparing costs across brokers.

For competition purposes, for brokers to provide competing research services, regulators need to recognise that there must be a mechanism for investment managers to receive research without paying the full cost in order to assess its ability to add value to the investment process. It is not in the clients' interests to pay full-price for a research service which has not yet been properly assessed and deemed sufficiently valuable by the investment manager.

The sell side must be able to provide a substantial stream of research over an extended period of time to a prospective client in order for them to assess its quality (i.e. a trial period). Simply providing a representative sample of past research papers does not provide sufficient information to make a decision. Without this possibility regulators will be creating barriers to entry and barriers to switching research providers.

Investment managers will need to assimilate all the various pricing models offered by the sell side and Independent Research Providers (IRPs), then take a business decision on how to meet the firm's requirements.

In particular where brokers are offering inconsistent models (not just differential pricing but a different way of organising the pricing, e.g. menu pricing v chargeable time), firms will need to adopt a clear approach to setting payments and negotiating with brokers. Investment managers will be looking to use the new pricing models to help budget formation.

The sell side have not yet publicly defined their pricing models but certain models may encompass some form of fixed access fee and a variable component based on usage. The fixed fee could include access to written research and some basic communication with analysts. The variable component will focus on substantive research service being provided in the analyst calls / meetings etc. The fixed access fee is necessary to satisfy the requirement that the investment manager pays something for the research they have received. That is, the investment manager cannot pay zero for research as this would be an inducement.

Where brokers are proactively providing unsolicited research to the buyside, it is the IA's view that once the investment manager has made reasonable and appropriate efforts to switch off such unsolicited activity, their obligations will be satisfied. The IA considers that the obligation would then substantially fall on the broker to comply with the MiFID II obligations not provide inducements.

A.5 GLOBAL STRUCTURES AND INTERNATIONAL CLIENTS:

Many firms are part of global groups and will have commensurate global relationships with their clients. The European requirements will have to be assimilated into these umbrella interactions. The MiFID II obligations in Europe go beyond many other non-EU country rules. The legal obligations will fall on the MiFID II management firm entity. As such firms will need to consider the impact given their specific legal structure.

If there is a global trading model in place at the investment manager then a new form RPA agreement would have to be put in place with non-EU entities of the broker. This could lead to difficulties as these markets would still be under the old structure. Without such new agreements in place it would lead to non-EU trading desks having to trade at an execution only rate, restricting commission generation opportunities and ultimately leading to under generation of research budgets.

In addition, to the extent that EU arrangements are inconsistent with those under other regulatory regimes (e.g. the US), firms may be required to split out order flow from EU clients which could have a negative effect on commission levels or execution. This could lead to a conflict between inducements and best execution obligations which will need to be resolved.

The IA would encourage the FCA to apply the MiFID II research rules to global groups with international clients purposively and proportionally by balancing EU consumer protection considerations against the expectations of international clients and the benefits of a globally compatible approach for such clients.

A.6 THE MECHANISMS REQUIRED TO TRANSITION TO ONE OF THE THREE OPTIONS IN THE NEW REGIME:

The MiFID II rules are set to apply from 3 January 2018. If applicable, investment managers should start now considering how they will run down any existing Commission Sharing Arrangements (CSAs) arrangements. Any remaining balances in CSAs should be refunded to clients by 3 January 2018 or moved into the new research budget. Depending on the detail of firms' CSA agreements, some brokers may be unwilling to refund existing balances. As such, investment managers should consider putting in place new documentation with the broker to support the MiFID II regulatory approach and begin to run down any existing CSA balances well in advance of 3 January 2018.

There may also be considerations about the method and basis for distribution of any remaining balance in the CSA. Assets Under Management (AUM) may be one input but may not a sufficient delineator on its own. Clearly the smaller amount to be dealt with, the less of an issue this will be. If transitioning to P&L, firms should consider how they will efficiently run down any existing CSA balances with their brokers and amend client documentation where applicable.

In addition wealth managers offering investment services which include a dealing or transaction fee charged to a client per trade should review such arrangements to ensure that they are compliant and that such charges are not used to circumvent the requirements of MiFID II.

A.7 APPLICATION OF VAT:

Following the release of the final research provisions there is no clarity on whether the VAT exemption for research, as currently applied, can continue post-MiFID II. It should be noted that HMRC confirmed in a letter dated 6 May 2005 that research is ancillary to execution, and therefore exempt from VAT.

Investment managers are now making commercial decisions without full knowledge of HMRC's approach to the VAT treatment. Investment managers will need to factor in possible additional VAT costs when examining the viability of the different research models.

There are three possibilities for firms to consider:

- The VAT exemption for research will continue.
- VAT will be applied to the procurement of research.
- There will be a partial continuance of the VAT exemption for firms operating model 3 (an RPA funded by commissions).

The third of these three options, in any event, requires a set of conditions (similar to the current LIBA[6] agreement and analogous to the Retail Distribution Review (RDR) VAT guidance) which may cause market distortions and not fit neatly with how research is supplied and used. At a minimum it would cause a different VAT outcome for those buying research out of P&L to those using RPAs.

B. MODEL 2: DIRECT CHARGE TO THE CLIENT TO FUND A RESEARCH PAYMENT ACCOUNT (RPA)

When operating an RPA, in addition to the requirements in section A firms will have to take into account the following issues.

B.1 ASSESSING THE QUALITY OF RESEARCH ON ROBUST QUALITY CRITERIA:

Article 13 (b) (iv) requires that:

"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."

[6] London Investment Banking Association (LIBA), now integrated into the Association for Financial Markets in Europe (AFME).

This should not be onerous for firms in the UK as investment managers will already be in compliance with the requirements of FCA PS14/7 (2014) that outlined evidential criteria for substantive research, which was formalised in COBS 11.6.5.E:

(1) Under COBS 11.6.3R (3)(c)(ii), for a good or service to amount to the provision of substantive research the relevant research must:

> *(a) be capable of adding value to the investment or trading decisions by providing new insights that inform the investment manager when making such decisions about its customers' portfolios;*
>
> *(b) whatever form its output takes, represent original thought, in the critical and careful consideration and assessment of new and existing facts, and must not merely repeat or repackage what has been presented before;*
>
> *(c) have intellectual rigour and must not merely state what is commonplace or self-evident; and*
>
> *(d) present the investment manager with meaningful conclusions based on analysis or manipulation of data.*

It is our view that continued adherence with this four criteria test will meet the MiFID II obligations as long as the firm can demonstrate it has sufficient systems & controls in place to show compliance.

A quality assessment would be required irrespective of payment method as it will form the basis of the price negotiations and so will require an increased level of detail on usage and value add. However, under a P&L model there will be no requirement to formally ensure that the above COBS criteria have been met.

B.2 DISCLOSURE TO CLIENTS- PRE-ONBOARDING AND PERIODIC:

Prior to onboarding, we consider that prospective clients can be given a basis point (bps) figure for investing in a particular fund. Depending on the exact approach to the direct charge, it is our view that a representative example, which may include an illustrative cash amount, of what a typical investor would pay for research would be sufficient to fulfil this obligation. That is, a customised example that is specific to the investment objectives and potential AUM of the prospective client is not required.

Article 13 (1) (c) (ii) requires that for those firms adopting an RPA approach annual information on the total costs that each client has incurred for third party research must be provided on a periodic basis (minimum annually). The investment manager could satisfy this obligation by disclosing how much the client has paid towards the specific research strategy or strategies they are correlated with. This is not required for those firms adopting a P&L approach.

On request, the firm must provide a detailed breakdown of what the research budget was spent on. The IA considers that this obligation does not require an analysis on an individual client level or at a firm level.

This requirement can be satisfied by a strategy level summary of:

- Providers paid from this account.
- Total amount they were paid over a defined period.
- Benefits and services received by the investment firm.
- How the total amount spent from the account compares to the research budget.

In regard to the benefits and services received by the firm, it is the IA's view that this can be satisfied by provision of information based on the SLA's with the brokers and Independent Research Providers. A breakdown detailing individual pieces of research received and phone calls made to analysts is not required to fulfil the regulatory obligations nor would it be useful to the client.

In addition to the periodic disclosure, Article 13 requires that firms agree with clients both the specific research charge and the frequency at which it will be deducted. This is a one-time requirement for all new clients. Following the initial ex-ante client agreement, any changes to the research budget and corresponding client charge can be done with only a notification. Further specific client agreement is not required.

B.3 LEGAL STATUS OF MONIES HELD IN AN RPA:

The delegated acts do not define the status of money held in RPA accounts. The IA considers that it is not client money under CASS. However if the RPA is administered by the broker it should not be on the broker's balance sheet, rather it should be the investment manager's money.

This requirement is a change to current practice and is likely to require a repapering exercise with firms' brokers. There are outstanding questions on whether the account can be held in trust. Our view is that the terms of the account should create a trust or segregated structure that has a robust set of requirements to ensure the required protections for the investment manager are in place.

The Delegated Directive does however establish that any remaining balance in the RPA that is not spent at the end of the period must either be rolled over or refunded to the client. If it is to be refunded, then at that point, it will become client money. Therefore firms will need to have in place procedures to closely monitor the balance in the RPA against payments out to ensure the budget is not under or over spent and minimise this issue.

Firms should consider the following sections of the delegated directive when considering the legal structure of any such Research Payment Account:

Article 13, (1)(b) (iii) - the investment firm is held responsible for the research payment account.

Article 13 (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.

Article 13 (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.

B.4 WHERE NOT ALL CLIENTS ARE PAYING THE RESEARCH CHARGE:

Following the implementation of MiFID II firms may face a situation where some clients have agreed to pay the separate charge for research and others have not. In this instance, in order to avoid cross subsidisation of those clients who are not paying, out of P&L, the firm should top up the RPA with the equivalent amount that those clients would have paid. Firms should have in place policies and procedures to ensure there is no cross subsidisation between clients.

If firms decide to go down the route of paying P&L for those clients not paying the specific research charge; they will have to manage the potential conflict between the firm and their clients. In order to achieve the firm's financial targets, there may be a cap or ban entirely on any research payments, either as part of the annual budgeting process or from part way through the financial year. The firm will need to manage the conflict between the firms' objectives and the need to purchase research which would potentially be in the investors' best interests.

The other alternative would be to exit any clients that refuse to pay the research charge. This would remove both the problem of cross subsidisation, as all clients would be paying on the same basis, and any conflict between the firm and its clients.

Firms should consider the situation where the investment manager is providing management services for a client who is not paying a separate charge for research. It should be noted that such a client may, in any event, be placed in a fund which has an associated research charge. Investment managers should consider how they will provide clarity to their clients on how this will operate in practice.

B.5 TIMING OF PAYMENTS:

Firms will need to consider the timing for charging clients. There is no detail within the rules on how this is to be achieved. In our view a 1/260 accrual with collections on a monthly basis would be sufficient to meet the requirements. Investment managers should also consider to what extent payments to providers should synchronise with collections from clients.

Where firms have annual budgets that are generated across the year through commissions but the payments to suppliers (independents in particular) are not synchronised, generation may not be in line with payments. Firms should consider how any frontloading of research requirements at the beginning of the year will be dealt with.

B.6 CLIENT RESEARCH CHARGE METHODOLOGY:

The basis for charging individual clients is not specified in the delegated directive. Firms have the freedom to determine their own charging structure. This is likely to be based on a range of inputs including but not limited to AUM, strategy, fund type etc. Firms must be able to demonstrate that their charging methodology represents a fair allocation of costs to each client. Clearly index trackers (or similar funds) should have no research charge. Investment managers will also need to be mindful of Article 13 (2) (b) that outlines:

"the specific research charge shall not be linked to the volume / or value of transactions executed on behalf of the clients."

In addition the Delegated Directive requires that firms regularly asses the research budget. As such firms should consider building flexibility into the charging structure such that it can reflect research consumption, the establishment of new funds, significant client entry & exit and new strategies.

C. MODEL 3: FUND AN RPA BY MAKING A CHARGE TO THE CLIENT ALONGSIDE TRANSACTION COMMISSIONS

This section only applies to those asset classes where CSAs are applicable (equities, Exchange Traded Funds (ETFs) etc). There are significant challenges for investment managers in interpreting the Delegated Directive to implement an model 3 RPA approach.

C.1 ALLOCATING COSTS TO CLIENTS:

The regulations require that firms will have to be able to allocate costs to clients in more detail than they have done previously. The starting point for meeting this obligation is the terms of business with the client.

These should state that research purchased from third parties will be used for the benefit of the clients in a given research strategy. However, this research may not be exclusively used for a specific research strategy and there will be cross fertilisation of ideas between teams at the investment manager. This is in the interests of the firm's clients as it results in economies of scale (as a broader range of research is available for the firm's clients as a whole) and efficiencies as it prevents overpaying for the same, or similar, research.

It is the IA's view that it is much more efficient to have processes in place to allow teams to share research and allocate the cost accordingly. A bureaucratic process to strictly silo and segregate research provision within the firm would be inefficient and not in the best interests of the client. Such an approach would limit economies of scale and may even lead to firms effectively paying twice for the same research. In many cases external research will form one input (of many) to an internally processed – substantively new – internal document, which is then circulated. Such documents would not be caught by the MiFID II provisions.

We are aware that some brokers require a login to their website in order to view research and that calls to research analysts are logged. This kind of platform is able to provide enhanced statistics to the investment manager on who in their firm is reviewing what research. This data could be used to drive allocations within the firm. Where such interactions data is available, investment managers should periodically re-evaluate how research is being used inside the firm to ensure costs are allocated appropriately.

A number of third party vendors currently offer metrics to show interactions between buy-side and sell-side. This could provide a platform for investment managers to track usage of different brokers research across the firm. Given the enhanced focus on such metrics it may be necessary to ensure procedures are in place to check the quality of such interactions data supplied by brokers.

A robust research budget, at a strategy level allocated to fund level via AUM would represent one baseline starting point for creating a charging mechanism.

C.2 CONFLICTS OF INTERESTS BETWEEN CLIENTS:

The MiFID II research provisions bleed into the best execution requirements. Article 13 (2) states that:

'…the specific research charge shall: (b) not be linked to the volume and / or value of transactions executed on behalf of clients.'

The firm must document and be able to demonstrate this. Article 13 (9) places an additional obligation on the broker such that:

'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.'

However it is possible that the best broker will also have the best research analysts and such a research-trading correlation may exist. In such cases the firm must have sufficient management information to demonstrate that transactions were executed with a particular broker because they provided best execution for any given trade at that time. Firms can also point to their organisational structure which creates functional independence of the trading desk from the investment decisions.

There are extensive best execution requirements on firms under MiFID I already, however this new extra layer of obligations may imply additional spend on management information to demonstrate these points to the regulator.

C.3 STRUCTURING AND OPERATION OF AN RPA:

One of the major challenges relating to the existence of an RPA is the additional layer of complexity. There is a question outstanding on whether the RPA is intended to be an actual account or rather an overarching process of accounting at client level for generation and spend. FCA or the European Securities Markets Authority (ESMA) will need to give guidance on the required approach.

If the RPA is a separate account, it will require at a minimum repapering with the broker and any outsourced aggregators (where firms are using one) to clarify ownership and control of the account. However if the RPA is an accounting structure at the client level, this would be separate from the infrastructure needed to pay research providers (including brokers).

We consider that in the RPA model the existing CSA architecture would fund the RPA. Current aggregators in the market are well placed to achieve this, but it would add a further cost to investment managers into the process, which ultimately feeds through to underlying clients and creates a drag on performance.

C.4 TREATMENT OF AGGREGATED TRADES:

In the event that a portfolio reaches its budget, firms would need to switch that portfolio to execution only trading. As orders are aggregated most firms will currently have no way of doing this or applying different rates to different portfolios. Such differential application of commission rates will be extremely complex operationally and it is not a widely used practice in the market today.

We consider that this would require an industry wide solution on both the buy and sell side to exchange the necessary information. This will be challenging and costly to implement in the limited time available.

CONCLUSION:

The industry understands the purpose of the new MiFID II research rules and is fully engaged with implementing in time for 3 January 2018. Where RPAs are used the new rules will generate much greater transparency and disclosure of research costs to the client.

However investment managers are now faced with significant changes to the existing market structure implied by the new rules and the task of determining a suitable way forward to fund future research requirements.

The IA would particularly highlight the need for further consideration on the following issues by regulators:

- A purposive interpretation of the legislation that does not require breaking down the allocation and disclosure obligations to such a granular level of detail so as to make compliance extremely onerous or impracticable.
- Sourcing research from US brokers.
- Application to fixed income research.
- Structure and operation of the Research Payment Account.
- Temporary access to a research service for the purpose of evaluation.

We would also call on the FCA and ESMA to provide a harmonised approach to research across the EU. Regulators in the UK and Europe should provide guidance that reflects the global business environment in which investment managers operate. The IA would support a harmonised approach to the implementation of the new research rules that takes into account compatibility with other major financial centres.

The IA will continue to work with members and across the industry to interpret the issues raised by the new MiFID II rules on research and find solutions.