**KEY POINTS**

- The payment for research with dealing commissions will be a prohibited inducement under MiFID II.
- Managers will either have to pay for research out of their own pockets or agree with each client to establish a research payment account (RPA) through which the client pays an agreed amount towards research used by the manager. Brokers are proposing to operate RPAs on behalf of their clients utilising their existing Commission Sharing Arrangements infrastructure. These two options may still present some complications for US broker-dealers, as direct payments out of pocket may impose regulatory obligations and create additional liabilities under the US Investment Advisers Act and firms will need to consider whether the RPA mechanism fits with existing US practice permitted under SEC guidance.
- Market commentary and issuer-sponsored materials provided by brokers to their portfolio manager and independent investment adviser clients which do not constitute research under MiFID II are likely to qualify as acceptable minor non-monetary benefits under the inducement rule.

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# MiFID II inducement rule: the impact on investment research and market commentary

The proposed MiFID II ban on payments for research with dealing commissions marks the latest and most radical in a series of regulatory "unbundling" measures which have emerged in various jurisdictions to enhance investment managers' client fiduciary duties as market structures evolve. The measures not only challenge accepted research provision models but also risk creating an un-level playing field with the US and other jurisdictions and further unwelcome tax and US regulatory consequences. Other market commentary and issuer-sponsored materials, whilst still permissible, may nonetheless be subject to the new investment recommendation requirements under the Market Abuse Regulation (MAR).

## USE OF DEALING COMMISSIONS: BACKGROUND AND HISTORY

Bundled brokerage and the payment of benefits out of dealing commission are a hangover from the pre-1986 era of fixed commissions when, unable to compete on cost, brokers instead competed on providing additional goods and services to investors alongside execution of transactions, known as "soft commissions". This might involve an investment manager on-charging to its clients the costs of additional non-execution goods or services including investment research, seminars, data price feeds or external publications. A review in 2001 by Paul Myners of institutional investment in the UK highlighted conflicts of interest and market distortion arising from bundled brokerage and soft commission arrangements.

The FCA's predecessor, the FSA, reviewed these arrangements following the Myners report and identified a number of market failures, in particular relating to transparency of the arrangements, the accountability of investment managers, the potential for conflicts of interest and lack of effective competition for those services typically bundled in with execution. A new dealing commission regime was brought in with effect from 1 January 2006, introducing new Handbook rules to restrict the range of goods and services purchasable with commission to execution and research-related goods and services, as well as an industry-led code of conduct for disclosure of goods and services paid for with commission.

The EU Markets in Financial Instruments Directive (MiFID) in 2007 brought in an inducement rule, which the UK gold-plated by retaining the domestic dealing commission rules it had introduced in 2006. A post-implementation review by the FSA of the 2006 regime and further thematic work then followed, covering issues such as value for money in research spend, the goods and services being purchased with commission, compliance with the evidential criteria for eligible research, the use and operation of Commission Sharing Agreements (CSAs), and conflicts of interest. Further amendments were made to the FCA rules in 2014, to clarify the evidential criteria for substantive research, and new guidance was introduced on corporate access and making mixed-use assessments where investment managers receive bundled services.

The development of the regime has therefore been marked by successive adjustments and narrowing of the scope of eligible goods and services that can be purchased with commission, rather than by structural change. As early as 2003 the FSA had originally been in favour of unbundling research just as its predecessor (the SIB) had been before it and had consulted on policy proposals to require managers to rebate research costs to their customers. This proposal was dropped at the time but is now due to resurface on MiFID II implementation, introducing a significant change to the current regime.

## MiFID II/MiFIR

MiFID is to be recast into a new Directive 2014/65/EU (MiFID II) and a linked Regulation (EU) no 600/2014 (MiFIR), both of which are due to be substantially transposed into local laws by 3 January 2018. MiFID II/MiFIR form the latest chapter in the evolution of the pan-European regulatory and passporting regime for investment services

**TABLE 1: USE OF DEALING COMMISSION: KEY REGULATORY MILESTONES**

| | |
|---|---|
| 1986 | The Big Bang: Fixed commission rules abandoned. |
| 2001 | Myners Review into institutional investment in the UK highlights conflicts of interest and market distortion from bundled brokerage and soft commission arrangements. |
| 2003-2005 | FSA review work driven by findings of the Myners Review, with focus on transparency, conflicts of interest, best execution and over-consumption of goods and services. FSA issues a series of consultations on rule harmonisation for bundling and soft commission and on the scope of goods and services that could be purchased under these arrangements. |
| 2006 | New regime comes into force:<br>➨ Clarification in FSA Handbook (with effect from 1 January 2006) that the scope of goods/services that can be paid for with dealing commission is restricted to execution and research-related goods and services.<br>➨ Industry-led disclosure code for investment managers' disclosures relating to costs of execution and research.<br>➨ Regulator's expectations that execution and research services are to be purchased and valued separately via clear payment and pricing mechanisms, such as the Commission Sharing Agreements (CSAs) commonly in use in the UK.<br>➨ If goods or services are not execution or research related, there is a general ban on investment managers making payment for these using dealing commission. |
| 2013-14 | FCA work narrows the perimeter of the regime (COBS 11.6) governing dealing commission, in particular by:<br>➨ Narrowing the range of permissible goods/services;<br>➨ Tightening the evidential criteria for permissible research; and<br>➨ Excluding corporate access from the list of permissible services that can be purchased with dealing commission. |
| 2014 | MiFID II Level 1 text released, introducing more onerous rules around inducements. Investment managers prohibited from receiving any third party inducements save for "minor non-monetary benefits". ESMA is tasked with providing technical advice for Commission Delegated Acts at Level 2.<br>FCA goes further than its previous stance, suggesting complete unbundling of research from dealing commission. In DP 14/3 (July 2014) FCA states that 'unbundling research from dealing commissions would be the most effective option to address the continued impact of the conflicts of interest created for investment managers by the use of a transaction cost to fund external research'. ESMA provides final technical advice to the Commission, advocating a narrow construction of "minor non-monetary benefits". |
| 2016 | Draft Commission Delegated Directive released on 7 April 2016.<br>Includes further detail on MiFID II inducement rule, permitted methods of payment for research and clarifications of acceptable minor non-monetary benefits. |

and activities, which commenced with the adoption of the Investment Services Directive in 1993. MiFID II/MiFIR also form a central component of the post-financial crisis regulatory reform agenda, is closely linked and coordinated with MAR, the European Market Infrastructure Regulation (EMIR) and other EU legislation and its measures are of high and broad impact across the financial sector.

## THE INDUCEMENT RULE

MiFID and its Level 2 measures currently require that the payment of fees or commissions and other non-monetary benefits be assessed to ensure they do not impair a MiFID investment firm's duty to act in the best interests of its client, that they "enhance the quality" of the service being provided to the client and that they are disclosed to the client. In the UK, these requirements have been implemented through COBS 2.3 of the FCA rulebook, which also applies to non-MiFID firms.

MiFID II (Art 24(7) and (8)) significantly tightens the inducement rule insofar as it applies to portfolio management and independent advisory firms. Certain inducements received by portfolio managers and independent advisors which are currently permissible under MiFID will be prohibited under MiFID II, except for minor non-monetary benefits capable of enhancing the quality of service provided to a client, which do not impair the manager's duty to act in the best interests of the client and are clearly disclosed.

## INDUCEMENTS IN RELATION TO RESEARCH

Commission Delegated Directive (C2016) 2031, Chapter IV sets out further detail in relation to the MiFID II inducement rule. Article 13 requires that the provision of research by third parties to investment firms providing investment services to clients shall not be regarded as an inducement if it is received in return for either of the following:

- Direct payments by the investment firm out of its own resources; or
- Payments from a separate research payment account (RPA) controlled by the investment firm, provided:
- the RPA is funded by a specific research charge to the client, which is pre-agreed with the client and regularly assessed;
- the firm has, and applies, a clear written policy to regularly assess the quality of the research, based on robust criteria and its ability to contribute to better research decisions;
- the firm provides information in advance to clients on the research budget for all

clients and the research charge for each client, as well as information on the annual cost each client has incurred for third party research and, on request by clients or competent authorities, amounts paid to providers from the RPA (via a clear audit trail) and how this compares to budgeted amounts (taking into account any rebated unspent sums);

- the research charge shall not be linked to the volume and/or value of transactions executed on behalf of the clients, shall not be influenced or conditioned by levels of payment for execution services and may not exceed the research budget.

The aim of these requirements is to de-link research use from trading volumes and avoid the over-consumption of research by portfolio managers.

"Research" in this context (according to Recital 28) includes research material or services concerning one or several financial instruments or other assets, or the issuers or potential issuers of financial instruments, or closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector. It should also explicitly or implicitly recommend or suggest an investment strategy and provide a substantiated opinion as to the present or future value or price of such instruments or assets, or otherwise contain analysis and original insights and reach 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 investment firm's decisions on behalf of clients being charged for that research. This definition does not appear to be limited to "independent research".

## INDUSTRY RESPONSE

Since RPAs will be permitted to be operated by third parties, brokers are planning to offer to operate RPAs on behalf of managers through their existing Commission Sharing Agreements (CSA) infrastructure, with modifications.

CSAs are a mechanism adopted by the brokerage industry following the 2006 FSA rule changes, to utilise the pre-existing infrastructure developed for soft commission to effect payments for research (instead of wider "softing" services) out of dealing commissions. In essence, as dealing commissions are received by brokers from investment managers, a pre-agreed proportion is placed into a research "bucket". At the end of a certain period, the investment manager instructs the broker to distribute the amounts in the "bucket" to research providers which it may nominate, which may include the broker's own research department. The broker would also provide reports and information regarding these payments to the investment manager, for the purposes of the manager's own disclosure obligations under the MiFID inducement rule.

In order to comply with the RPA requirements, the modified CSA infrastructure would need to be operated in the following manner:

- the absolute numeric amount to go into the "bucket" in a given period (eg a month) would need to be pre-determined and agreed with the investment manager, who in turn agrees it with its clients;
- the "bucket" may be filled up to this limit by the broker placing a pre-agreed proportion of the relevant investment manager's dealing commissions into it;
- however, once the absolute limit is reached for a particular period, the basis of trading commissions is switched to "execution only" until the amount in the bucket is paid away and a new period commences;
- the limit may be hit in respect of different underlying fund clients at different times, so the execution-only basis of trading may also kick in at different times, with the investment manager paying a blended rate of commission, some being execution-only and some including RPA-eligible research payment amounts.

Some investment managers have stated that they will not utilise RPAs and will be paying for research directly out of their own pockets and, as a response, some brokers are building invoicing mechanisms for their research.

## IMPLICATIONS AND CONSEQUENCES

Before the detail emerged in the Delegated Directive, the concern of the industry was that if there was no mechanism for research to be paid for out of dealing commissions and it had to be separately charged to the investment managers, the production of research would become uneconomic, the quality would diminish and SMEs would cease to be covered. Furthermore, there was a concern that VAT would be chargeable on a standalone research product which is no longer part of brokerage intermediation. In addition, there was also a concern that the production of standalone research could constitute an activity requiring registration under the US Investment Advisers Act 1940 (Advisers Act): a particular concern for global investment banks with global research departments. There are also grave concerns expressed by fixed income market participants as to how the rules will in practice apply to fixed income markets, which generate revenues through spreads and not commissions.

The proposals in the Delegated Directive to effectively allow payments out of dealing commission to be made through an RPA (subject to rigid constraints) may alleviate these concerns to some extent, though it is by no means certain that they will be fully removed. At present, it is not known whether RPAs can practically be created for fixed income and other dealer markets.

## THE VIEW FROM THE US

Although the MiFID II inducement/investment research rules apply only to EU investment firms (so, for example, US investment managers with no EU presence would not be subject to the rules), they have significant cross-border implications. Many investment firms and their service providers are complex, cross-border businesses, with cross-border clients, so in many instances, determining the scope of these rules and drawing clean and clear lines will be onerous and difficult. Also, EU investment managers will need to apply the rules to non-EU brokers and service providers and, from a US legal and regulatory perspective, the direct payment and RPA models raise some potentially difficult issues and questions.

### Direct payments

As we noted above, some European investment firms have already announced that they will follow the direct payment option. From a US perspective, this is highly problematic and many US broker-

dealers have been historically reluctant to accept so-called "hard dollar" payments from investment manager clients because of concerns that such payments could potentially subject the US broker-dealer to regulation as an "investment adviser" under the Advisers Act.

Specifically, s 202(a)(11) of the Advisers Act defines an "investment adviser" as any person or firm that:

- for compensation;
- engages in the business of;
- advising others, either directly or indirectly or through publications and writings as to the value of securities or as to the advisability of investing in, purchasing or selling securities; or
- who, for compensation and as part of a regular business, issues or promulgates, analyses or reports concerning securities.

Importantly, s 202(a)(11)(C) of the Advisers Act provides an exemption from the definition of "investment adviser" to any broker or dealer whose provision of investment advice is solely incidental to the conduct of its business as a broker or dealer and who receives no special compensation for providing such advice. Consequently, the risk to a US broker-dealer in accepting direct payments from an EU investment firm would be that such payments would constitute "special compensation".

There are many consequences for a broker-dealer of being required to register as an investment adviser. Fundamental to the Advisers Act is the notion that an adviser is a fiduciary to his client and, as a fiduciary, an adviser must avoid conflicts of interest with its clients and is prohibited from overreaching or taking unfair advantage of a client's trust. While some major US broker-dealers are also registered as investment advisers, their research analysts are not directly employed within the registered investment advisory entity. In practice, the research businesses within many of these integrated broker-dealers do not operate to the full standards of the Advisers Act and are not considered by their clients as investment advisers.

One particularly adverse consequence of a broker-dealer being required to register as an investment adviser under the Advisers Act stands out for broker-dealers who trade on a proprietary basis. Section 206(3) of the Advisers Act prohibits an investment adviser from trading as principal with an advisory client without disclosing its capacity in writing and receiving client consent to the transaction.

## Research Payment Accounts (RPAs)

The RPA model set out in the Delegated Directive reflects in many respects the structures followed by client commission arrangements (CCAs) in the US and their UK/European equivalent (CSAs), but with a more rigorous control and governance framework. CCAs have been used in the US market since 2006, following interpretative guidance issued by the US Securities and Exchange Commission (SEC) around client commission practices covered by s 28(e) of the US Securities Exchange Act of 1934 (s 28(e)). Section 28(e) is a safe harbour that allows an asset manager to use client funds (commissions) to purchase "brokerage and research services" provided by a broker-dealer without breaching their fiduciary duties to such accounts. Under s 28(e), an asset manager must determine in good faith that the amount of commission was reasonable in relation to the value of the brokerage and research services received. If an asset manager pays for such services in circumstances that do not fall within s 28(e), it could be liable for breach of its fiduciary duties under US state or federal laws; moreover, any broker-dealer that executes such trades could be liable for aiding and abetting the breach of fiduciary duty by the money manager.

From a US regulatory perspective, CCAs and their UK/European equivalents that are structured in accordance with the SEC's guidance are not problematic. A more subtle question that the market will grapple with in the near term is determining to what extent the RPA model fits within that existing interpretative framework.

## MARKET COMMENTARY, SALES NOTES AND ISSUER-SPONSORED MATERIALS

As stated, the provision of "non-independent research" may be caught by the MiFID II inducement rules in relation to research.

Concerns have also been raised as to whether other non-research materials such as sales notes provided in return for dealing commissions could constitute a prohibited inducement.

Under s 24(9) of MiFID II, investment firms paying or being paid any fee or commission or providing or being provided with any non-monetary benefit (by someone other than the client) in connection with the provision of an investment service or ancillary service to the client must ensure that the benefit is designed to enhance the quality of that service to the client.

Under Art 11(2) Delegated Directive, a fee or non-monetary benefit is considered to enhance the quality of the service to clients if:

- it is justified by the provision of an additional or higher level service to the relevant client, proportional to the level of inducements received;
- it does not directly benefit the recipient firm, its shareholders or employees without tangible benefit to the relevant client;
- it is justified by the provision of an on-going benefit to the relevant client in relation to an on-going inducement.

The inducement must not prevent the firm from acting honestly, fairly and professionally in accordance with the best interest of its clients. There are two routes by which sales notes and market commentary should avoid being inducements: by being fully integrated into the sales process or by constituting an acceptable minor non-monetary benefit.

## Integration into the dealing process

Sales notes and market commentary are frequently an integrated part of the dealing process in that they provide pre-contractual information concerning the financial instruments being arranged or dealt with and assist in communications with the client and as such should be regarded as an integral part of the whole sales process, not being distinct items that can be distinguished as separate, identifiable inducements.

*Biog box*

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## Minor and non-monetary benefits

Minor and non-monetary benefits that are capable of enhancing the quality of service provided to a client and could not be judged to impair compliance with the investment firm's duty to act in the best interest of the client are excluded from the MiFID II prohibition on inducements. Article 12(3) of the Delegated Directive allows (among other things) the following as acceptable minor non-monetary benefits:

- information or documentation relating to a financial instrument or an investment service that is generic in nature or personalised to reflect the circumstances of an individual client (defined, under Recital 29, to include non-substantive material or services consisting of short term market commentary on the latest economic statistics or company results for example or information on upcoming releases or events, which is provided by a third party and contains only a brief summary of its own opinion on such information that is not substantiated nor included in any substantive analysis such as where they simply reiterate a view based on an existing recommendation or substantive research material or services, can be deemed to be information relating to a financial instrument or investment service of a scale and nature so that it constitutes an acceptable minor non-monetary benefit); and
- written material from a third party commissioned and paid for by a corporate issuer to promote a new issuance by the company, provided the material contains appropriate disclosures and is made available to any investment firm wishing to receive it or to the general public, is also a minor and non-monetary benefit.

## Market Abuse Regulation

Market commentary and sales notes may also fall within the definition of "investment recommendations" under the EU Market Abuse Regulation (MAR) implemented on 3 July 2016 which, as stated, has a degree of inter-dependence with MiFID II. MAR (via its delegated acts) provides harmonised standards with respect to investment recommendations to ensure that information is objectively presented and conflicts of interest are effectively disclosed. It sets out a list of prescribed disclosures which must be made on all investment recommendations relating to the author, sources, valuation methodologies and assumptions, as well as the disclosure of any meaningful positions held by the broker in the security concerned. The implications of MAR on investment recommendations will therefore also need to be considered alongside MiFID II.

Market participants are currently preparing for implementation of the MiFID II inducement rule on the basis that the Delegated Directive represents substantially the final stance of the European Commission. However, they need to be aware that further detail may emerge in the Level 3 technical standards which, although unlikely to change the substance, may impact the precise mechanics of any arrangements. In addition, national regulators could "gold plate" MiFID II and there may well be local implementation anomalies in various jurisdictions. Given how vocal FCA and its predecessor regulators have been over the years in relation to use of dealing commission and related areas, the industry will need to pay careful attention to any future FCA consultations on the implementation of the new rules. ■

*Further Reading:*

- MiFID II: regulating investment firms from the inside out [2015] 6 JIBFL 364(B).
- MiFID II: the hoops and hurdles which will restrict access to the EU market [2014] 4 JIBFL 252.
- LexisNexis Financial Services blog: Draft technical standards – don't be MiFID.

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