

FINANCIAL REGULATORY QUICK START GUIDE

MIFID II - RESEARCH

MiFID II introduced new rules requiring the “unbundling” of research costs from execution costs. This means that asset managers must pay separately for research and execution services. Post-Brexit, these rules continue to apply under both EU and UK MiFID.

RULES ON INDUCEMENTS

MiFID II contains a ban on the receipt of inducements by investment firms providing independent advice or portfolio management services to clients (i.e., asset managers). There is an exception for the receipt of “minor non-monetary benefits”.

The legislation sets out an exhaustive list of what may count as a minor non-monetary benefit.

Acceptable minor non-monetary benefits

Generic or personalised information or documentation relating to a financial instrument or an investment service

Written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company

Participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service

Hospitality of a reasonable *de minimis* value

There is flexibility for national regulators to add to this list. In the UK, prior to Brexit the FCA added free research trial periods and connected research linked to new issuances to its list of acceptable minor non-monetary benefits. Post-Brexit, it is also adding fixed income research, research provided by independent research providers, and openly available research to the list of minor non-monetary benefits. Both the EU and the UK also plan to add a new exception for SME research, but with slightly different parameters.

The definition of “minor non-monetary benefit” may also include non-substantive material, or services consisting of short term market commentary on the latest economic statistics or company results. However, it will not include substantive research or any benefit that involves the allocation of valuable resources.

Acceptable minor non-monetary benefits must be capable of enhancing the quality of the service provided to the client, be reasonable and proportionate, and be of such a scale that they are unlikely to influence the asset manager’s behaviour in any way that is detrimental to the interests of the relevant client.

Further, the fact that the firm receives a minor non-monetary benefit must be disclosed to the client prior to the provision of the relevant services.

As substantive research cannot qualify as a minor non-monetary benefit, in the absence of any specific carve-out for research, its receipt by asset managers would not be permitted under MiFID II.

RULES ON RESEARCH

However, MiFID II provides that research will not be classed as an inducement (and therefore may be accepted) if it is paid for by the asset manager in one of two ways:

- By the firm itself, out of its own resources; or
- From a Research Payment Account (RPA), which must be set up and operated in accordance with the prescriptive requirements under MiFID II.

This effectively requires the unbundling of research and execution costs.

The rationale behind this rule is to ensure that asset managers properly monitor the amounts paid for research, and ensure that research costs are incurred in the best interests of clients.

MiFID II also requires that, where a MiFID broker-dealer is providing both research and execution services to a MiFID firm, the broker-dealer must split out the costs of research and execution services. This is to help enable MiFID asset managers to meet their obligations.

WHAT IS RESEARCH?

For these purposes, research is defined as including research material or services relating to:

- One or more financial instruments or other assets;
- The issuers or potential issuers of financial instruments; or
- A specific industry or market such that it informs views on financial instruments, assets or issuers within that sector.

Research must 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 the relevant financial instruments or other assets. In our view, to be a substantiated opinion, a piece needs to set out a rounded view of the various key aspects of an investment decision, rather than providing a comment on a single issue relevant to a company.

Alternatively, it may 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 firm's decisions on behalf of clients being charged for that research.

Firms must take care to ensure that they classify research correctly, as anything that does not qualify as research under the rules must not be paid for out of an RPA.

Firms also need to remember that the definition of "research" for the purposes of the MiFID II inducements regime is distinct from the separate MiFID concept of "investment research" and the Market Abuse Regulation concept of "investment recommendations". The latter could include, for example, a comment on a single issue relevant to a company.

EXTRATERRITORIAL IMPACT

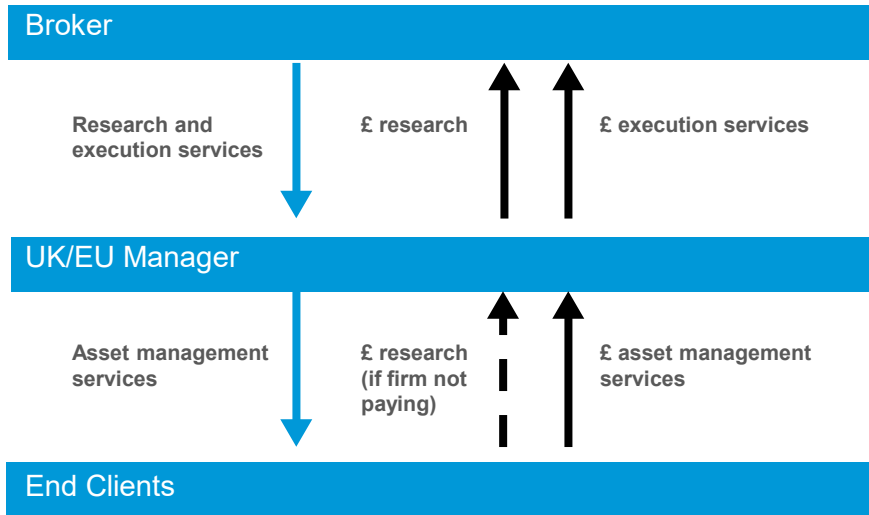
Although the MiFID II rules on research do not apply explicitly to broker-dealers outside the UK/EU, they do affect so-called "third country" firms indirectly.

This is because UK/EU asset managers must pay for research separately, even when it is provided by a third country firm. Therefore, UK/EU asset managers must ask all of their research providers to price their research separately. This enables UK/EU asset managers to meet their own obligations under MiFID II.

However, in some jurisdictions it is problematic for broker-dealers to receive separate payment for research, as this has unfavourable consequences under their own domestic regulation.

This issue has been particularly acute in the US, where the receipt of separate payments for research by a broker-dealer leads to the loss of an exemption from additional regulation by the SEC as an investment adviser. Investment adviser status brings with it a number of burdensome regulatory obligations, including most significantly fiduciary duties.


Relief from this issue has come from both sides. The European Commission confirmed that an EU asset manager may pay a single commission for research and execution services to a third country broker-dealer, provided that the payment attributable to research can be identified. The FCA confirmed that it will take the same approach post-Brexit. However, the US relief is temporary in nature, and is due to expire on 3 July 2023.



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