Topic: Inducements and investment research

Impact severity: red

The way in which discretionary managers and independent advisers are able to obtain investment research will fundamentally change. These firms will need to identify where across their business they receive investment research and decide how they will comply with MiFID II – they must either pay out for it of their own resources or through client research charges (in which case significant operational changes will be required).

Key changes:

- The general rule for all MiFID firms on permitted inducements is tighter with a new requirement that inducements must be designed to enhance the quality of the firm’s service.
- Investment research (IR) will be subject to the inducement restrictions in MiFID II unless it is purchased from the firm’s own resources or a research payment account (RPA) funded by clients. For discretionary managers and independent advisers, these are the only means for them to procure IR (as they are prohibited from accepting inducements).
- ‘Sell-side’ firms providing execution and research services to MiFID firms must price and supply these services separately.

Priority impact areas:

Key sources:

MiFID II: Recitals 74 to 76 and Articles 24 (7)-(9)
MiFID II Delegated Directive C(2016) 2031: Recitals 21 to 30 and Articles 11 - 13
ESMA Q&A on MiFID II and MiFIR investor protection topics (2016/1444)
FCA Commentary: Chapter 10 of DP 15/3, Chapter 3 of CP 16/29 and Chapter 6 PS17/14
FCA Handbook: COBS 2.3A-3C

FCA implementation:

- The rules on inducements and investment research will apply to Article 3 firms and third country branches carrying on equivalent MiFID business.
- The FCA intends to extend these provisions to MiFID exempt fund managers including UCITS management companies, full-scope AIFMs, small authorised AIFMs, CIS operators as well as incoming EEA AIFM branches.
- The MiFID II rules on inducements are set out in new COBS chapters: COBS 2.3A, 2.3B and 2.3C. COBS 11.6 (on soft commissions) is superseded by these new rules and are largely deleted. Existing general inducement rules in COBS 2.3 remain for non-MiFID business.

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Comments and observations on inducements and investment research

General restriction on inducements: the general restriction on inducements will be tighter under MiFID II. In particular, firms may only accept inducements which do not impair on the firm’s duty to act in the client’s best interest and which are designed to enhance the quality of the relevant service. The MiFID II Delegated Directive introduces prescriptive criteria as to what ‘enhancing the quality’ of a service can consist of, with correspondingly tight rules around record keeping and disclosure.

Also note that independent advisors, restricted retail advisors and discretionary managers are prohibited from accepting any inducements under the FCA’s implementation of MiFID II unless they are acceptable minor non-monetary benefits (see our RDR Equivalent Sheet for more information on this topic).

Research and acceptable minor non-monetary benefits: the prohibition against discretionary managers and independent advisors accepting inducements does not apply to ‘acceptable minor non-monetary benefits’. The scope for IR to fall within this category is very limited and recitals to the MiFID II Delegated Directive indicate that only non-substantive material or promotional material commissioned by an issuer is likely to be exempted.

Investment research as an inducement: however, IR will not be regarded as an inducement (and so is permitted) if it is paid for out of the firm’s own resources (as to which there are limited guidelines although research would need to be purchased at its unbundled price) or out of an RPA which is funded by clients and meets certain conditions. For discretionary managers and independent advisers subject to the prohibition on inducements, these are the only means of procuring IR.

Research Payment Accounts: RPAs are a new concept under MiFID II. The core features of an RPA are as follows:

- It is funded by a specific research charge to clients set by the firm in accordance with a research budget (and not based on the volume or value of transactions). The research budget does not need to be set at an individual portfolio level, but can apply to a number of portfolios that share similar strategies and objectives. Firms must have robust systems and controls to ensure a fair allocation of research costs between clients and be able to justify any budgetary groupings.
- The firm must regularly assess its research budget and the quality of the research purchased (in accordance with a robust quality criteria). To that end, firms must maintain a written RPA policy which is available to clients.
- Funds in the RPA can only be used to purchase research. If there is a surplus in the RPA at the end of a period, it must be rebated to clients or offset against the budget and charges for the following period.
- Clients must be provided with information about the research budget and estimated charges before the provision of services. Furthermore, clients must be provided on an annual basis with information on the research costs incurred and, on request, the payments made.

Funding RPA by collecting charges alongside transaction costs: MiFID II does allow for research charges to be collected at the same time as other transaction costs although research charges collected in this way must be swept into a segregated RPA over which the firm has control. Existing Commission Sharing Agreement accounts with brokers will require significant changes to comply with the new rules.