

MiFID II ALERT - USE OF DEALING COMMISSIONS TO PURCHASE INVESTMENT RESEARCH

ESMA has published proposals which clarify when it will be permissible to use client funds to purchase investment research under MiFID II.

BACKGROUND

MiFID II states that when an investment firm provides portfolio management, or investment advice on an independent basis, it must not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by a third party in relation to the provision of the service to clients. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client are permissible, so long as they do not adversely affect the investment firm's duty to act in the best interest of the client and are clearly disclosed to the client.

In its May 2014 consultation paper (ESMA/2014/549), ESMA mooted its view that for financial analysis to be acceptable it would need to be intended for distribution (that is, accessible by a large number of people at the same time). On the other hand, research for a specific portfolio manager would be unlikely to constitute an acceptable non-monetary benefit. These proposals caused consternation across the financial services industry.

CURRENT PROPOSALS

In its Final Report published today ([ESMA's Technical Advice to the Commission on MiFID II and MiFIR](#)), ESMA proposes that payment for research should be acceptable only where it is not linked to the payment made for execution of orders. ESMA specifies that the receipt of research should not be regarded as an inducement if it is received in return for:

- ♦ direct payments by the investment firm out of its own resources (which, it is recognised, may be reflected in an increase in fees); or
- ♦ payments from a separate research payment account controlled by the investment firm.

In relation to the operation of a separate research payment account, ESMA stipulates that (in summary):

- ♦ the research payment account must not be used to fund internal research;
- ♦ the research payment account is funded by a specific research charge to the client which is based on a research budget set by the investment firm and which may not be exceeded;

- ♦ the charge and its frequency must be agreed with each client;
- ♦ the charge may be increased only with the client's written agreement;
- ♦ any surplus in the research payment account should be rebated/offset to benefit the client;
- ♦ the charge is not linked to the volume and/or value of transactions executed on behalf of the clients;
- ♦ the investment firm must set and regularly assess a research budget as an internal administrative measure which is based on a reasonable assessment of the need for third party research;
- ♦ the allocation of the research budget to purchase third party research should be subject to appropriate controls and senior management oversight to ensure it is managed and used in the best interests of the firm's clients. It is essential that firms have a clear audit trail of payments made to research providers and evidence of how the research met ESMA's quality criteria to be paid for from the research budget;
- ♦ firms should have in place (and provide it to clients) a written policy to assess the quality of the research, its ability to contribute to better investment decisions and the apportionment of research costs as between different clients. Such decisions and policies should be regularly reviewed;
- ♦ ex-ante, clients should be informed about the budgeted amount for research and the amount of the expected research charge for each of them; and
- ♦ ex-post, clients should receive annual information on the total costs that each of them has incurred for third party research.

Any firm using a research payment account is required, upon request by its clients or by competent authorities, to provide a summary of the providers that were paid from this account, the total amount paid over a defined period, the goods and services received by the investment firm, and how the total amount spent from the account compares to the budget set by the firm for that period – noting any rebate or carry-over if residual funds remain in the account.

To assist investment firms in implementing these changes relating to the use of dealing commission for investment research, ESMA advises the Commission that brokers should price and supply execution and research services separately.

In addition, taking heed of industry concerns about the lack of a level playing field, ESMA advises the European Commission to align the UCITS Directive and the AIFMD with these changes.

NEXT STEPS

The Commission will now consider ESMA's final advice. The delegated acts are intended to apply 30 months following the entry into force of the Directive and Regulation (the same date as the bulk of MiFID II and MiFIR, on 3 January 2017).

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