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Back to the (bundled research) future

FCA proposals for amendments to the MiFID2 research payment rules

On 10 April 2024, the FCA published a consultation paper (CP24/7) on *Payment Optionality for Investment Research*. The FCA proposes that UK firms should be permitted to pay for research using bundled payments, as a new third option alongside the existing RPA and P&L models.

This proposal represents a significant reversal of the mandatory unbundling requirement, which many will remember was one of the headline regulatory changes under MiFD2 in 2018. This will be an important option for asset managers who wish to return to a bundled model for research. However, the devil is in the detail, and it may be that some of the mandatory "guardrails" proposed by the FCA make this a less compelling option for firms than might be hoped at first glance.

This note sets out a summary of the proposals in the consultation, and how it will impact UK firms which purchase and consume investment research.

1. What's the current situation?

Under the MiFID2 inducements rules, investment managers and investment advisers are prohibited from receiving benefits from third parties, including third party investment research.

This inducements ban does not apply to either: (i) benefits which fall within an expressly defined list of acceptable minor non-monetary benefits (**AMNMBs**) or (ii) third party research which is received in accordance with the permitted mechanisms for receiving research.

Under MiFID2, the only permitted routes to receive research are either:

- **P&L:** where the investment firm pays for the research from its own resources or
- **RPA:** the firm's client pays for the research through a research payment account which is operated in compliance with detailed technical requirements. The RPA may be funded either by a separate research charge paid by the client to the manager directly, or by the trade-by-trade collection of a research charge alongside the dealing commission.

MiFID2 reversed the prior regime under MiFID1, which permitted firms to receive research on a bundled basis or using soft dollars / soft commission.

2. What's the context to the FCA's consultation?

The MiFID2 research unbundling requirements were widely criticised in the market, as the RPA is seen as unduly complex to operate, and the P&L model may penalise smaller firms which are less able to afford third party research.

The unbundling requirements also impede the ability of UK firms to obtain research from US broker-dealers (which are not permitted to receive hard dollar payments for research, following the expiry in July 2023 of the SEC no-action letter, which had permitted such hard dollar payments for a transitional period after MiFID2 came into force).

Consequently, the UK government undertook to review the rules as part of the Edinburgh Reforms. July 2023's UK Investment Research Report recommended (amongst other things) that UK asset managers should be permitted to pay for research on a bundled basis.

The purpose of the FCA's consultation is to give effect to that specific recommendation, by proposing amendments to the FCA inducements rules and research payment rules, to allow the receipt of bundled research and commission sharing arrangements.

It may be helpful to provide a brief summary of the general operation of this model, for those readers who are not familiar with the former (pre-2018) model.

- **Bundled research:** in a bundled research model, an investment manager agrees with an executing broker to execute trades (typically in relation to equity instruments) for a higher commission rate than would otherwise be charged by the broker only for the execution of the trade. The additional commission element is then effectively used to pay for research that the investment manager has received from that broker, but *without* making a separate / unbundled cash payment to the broker (known as **hard dollars**).
- **Commission sharing agreement (CSA):** a CSA is a framework agreement between an investment manager (or its clients) and an executing broker or prime broker, under which trades are effected at an agreed, increased commission rate with the broker. This commission rate includes both an element for the costs of executing the trade, and also an additional commission element which is then allocated into a soft commission pool. The investment manager may direct the broker to pay certain third party suppliers from this commission pool, using the surplus commission not allocated to the broker operating the commission pool. This similarly facilitates paying research providers with soft dollars, not hard dollars.

In the consultation paper, when the FCA refers to **bundled payments** (also called **joint payments** in the draft COBS rules), the FCA is referring to either or both of bundled research and CSA arrangements.

3. What does the FCA propose?

The FCA is proposing to introduce a new option, to allow firms to pay for research using bundled payments for research and execution services, without breaching the inducements rules. The bundled payments model will be subject to new mandatory "guardrails" – see section 4 of this note below, for more details.

This new bundled payments option would exist alongside the existing RPA and P&L models (in other words, it will be permitted to retain the MiFID2 unbundled models, if preferred).

The existing AMNMB exemptions will also remain in place (subject to the proposed amendments described below). As such, firms can continue to receive research for free, so long as the relevant research falls within a category of AMNMB.

4. What are the guardrails for using the bundled payment model?

There will be eight new mandatory requirements associated with the use of the new bundled payments model. In summary, a firm using bundled payments will need:

	Requirement	Detail of requirement
1	**A formal policy describing the firm's approach to bundled payments**	This describes the firm's approach to bundled payments, and specifies how the firm's controls around bundled payments operate (and operate separately from trade execution).
2	**Agreements with research providers**	These agreements must cover the methodology for calculating and identifying the cost of research. The FCA states that this is intended to promote price discovery and transparency.
3	**A structure for the allocation of payments between research providers**	This includes payment allocations to both executing brokers and independent research providers. The FCA says in the consultation that this will allow for alignment with the CSA payment structure which is typical in the US.
4	**Operational procedures for the administration of accounts used to purchase research**	This includes reconciliation and reporting, and to ensures timely payments to providers. The FCA notes that, unlike the RPA model, there is no requirement for monies to be swept into a bank account belonging to the investment manager.
5	**A budget to establish the amount needed for third party research**	This budget must be reviewed and renewed at least annually. The budget must be based on the expected amounts needed to purchase research (as opposed to volumes or values of trade executions). The budget must be set at appropriate aggregated levels – i.e. for similar strategies or clients who would benefit from the same research. In addition, the firm's policy must set out what actions to take if the research charges exceed the budget, or the budget is increased.
6	**An approach for the allocation across clients of the costs of research purchased through bundled payments**	The FCA says in the consultation paper that relative costs incurred by clients must be commensurate with the relative benefits received. However, the specific costs of individual items need not be attributable to individual clients.
7	**An annual assessment of value**	The firm must periodically assess the value, quality and use of research purchased using bundled payments. The firm must also benchmark prices paid for bundled research against relevant comparators, to ensure that they are reasonable.

8	**Client disclosures**	These must cover: • the use of bundled payments • the key features of the firm's approach to implementing the bundled payment option • if and how bundled payments are combined with any other payment option • the expected annual costs (as part of ex-ante costs and charges disclosure) • the most significant research providers • the costs incurred In a contrast to the RPA rules, there is **no proposed regulatory requirement for client consent**. There may however be contractual requirements or existing operational reasons why client consent is necessary in practice.

In addition, best execution rules remain in place. In particular, research services must not be a factor in assessing best execution.

5. Which firms will be affected by these changes?

The changes will impact UK FCA-authorised MiFID firms, which are subject to the inducement rules in FCA COBS 2.3A and the research payment rules in COBS 2.3B.

Given that there is a very wide AMNMB exemption for FICC research, in practice these changes may be more relevant to UK firms with equities strategies. (In other words, because it is permissible to receive FICC research for free in the UK, there may be less need in practice to implement a bundled model).

The FCA has said that it will separately consult on how the changes can be mapped across to UK AIFMs and UK UCITS Mancos, under the equivalent rules in COBS 18. It appears that the FCA's intention is that whatever changes are made to the MiFID regime should also be made to the fund management regime.

Non-UK investment managers will not be impacted by these changes. Although this will amend UK MiFID, EU MiFID firms subject to EU MiFID are not impacted.

6. Are there other changes proposed?

Yes, two further changes are proposed.

- The FCA proposes to add to the list of AMNMBs a new express exemption, which confirms that short-term trading commentary is an AMNMB. As such, short-term trading commentary may be received by a UK firm for free, without breaching the inducements rules.
- Separately, the FCA also proposes to delete the existing AMNMB exemption relating to research on companies with a market capitalisation of less than GBP 200 million, on the basis that the new option for bundled payments can apply to research on companies of any size and to avoid any additional complexity in the rules. (The equivalent AMNMB exemption relating to corporate access for such issuers would remain in place).

7. What will be the options for receiving research, if this is adopted?

If all of the changes proposed in the consultation paper are implemented, then UK investment managers will have the following options for acquiring investment research:

AMNMBs	P&L model	RPA model	Bundled payments model *[NEW]*
A firm may receive any of the following for free, as an AMNMB: • Generic information • Issuer-sponsored research • Research received during a trial period • Research related to fixed income, currency or commodity (**FICC**) instruments • Research from an independent research provider that is not part of a financial services group • Openly available / publicly available research • **Short-term trading commentary, linked to trade execution services *[NEW]***	Separately from the AMNMB exemptions, a firm may receive research in return for direct payments by the firm out of its own resources (P&L).	Separately from the AMNMB exemptions, a firm may receive research in return for payments from a separate RPA, provided that: • the RPA is funded by a specific research charge to the client • the manager must set and regularly assess a research budget as an internal measure • the manager must regularly assess the quality of the research purchased • the manager makes prior, ongoing and ad-hoc disclosure of the use of the RPA • the manager obtains and documents the client's agreement to use of the RPA • the manager complies with governance, oversight and control requirements	**Separately from the AMNMB exemptions, a firm may receive research in return for bundled (joint) payments for third party research and execution services, provided that the manager implements:** • **agreements with research providers and structures for allocation of payments** • **a budget to establish the amount needed for third party research** • **an approach for the allocation across clients of the costs of research purchased through bundled payments** • **an annual assessment of value** • **client disclosures**

8. What's the timing?

The FCA has launched an 8 week consultation period, which will remain open until 5 June 2024.

The FCA has said it then aims to publish its finalised rules and guidance in the first half of 2024 (i.e. before the end of June 2024).

9. What should we do, if we want to use the bundled payment model?

As a first point, the consultation paper sets out proposed draft rules, not final rules. Firms will need to wait for the final rules to be published, before making any firm commitments around bundled payment models. In addition, fund managers (AIFMs or UCITS Mancos) will also need to wait for the parallel rules for those firms to be published.

Assuming that the rules are implemented as proposed, then firms will (if they choose to do so) be permitted to move to a bundled payments model for research. In order to do so, firms will need to comply with the conditions summarised above.

In particular, you will need to focus on implementing a bundled payments policy, and related internal processes. You will need to set a budget as well as related budgeting procedures. You will need to enter (or amend) agreements with research providers. On the client-facing side, you'll also need to update disclosures, and potentially terminate any existing RPA arrangements. As a practical matter, it will also be necessary for sell-side brokers to update their processes, to allow for the provision of research to investment managers on a bundled basis and/or the operation of CSAs on behalf of investment managers.

Simmons & Simmons would be pleased to discuss this further with you.

10. What does Simmons & Simmons think?

It makes for great headlines to say that the FCA is reversing the little-loved MiFID2 research rules. Certainly, it's a net positive for the asset management industry for the FCA to reintroduce the option of allowing bundled payments for research. It removes a competitive disadvantage for UK firms, and allows global groups (and particularly US-headquartered alternative firms) to apply a more consistent research-purchase model.

However, more than half a decade after MiFID2 came into force, firms may be excused for feeling that these proposals are too little, too late. While the proposals do at face value reinstate bundled research, there are prescriptive conditions associated with the use of the model. Although the FCA professes that the bundled model will be operationally easier than RPAs, there doesn't appear to be a huge substantive difference in the operational requirements.

There will no doubt be a group of firms (perhaps smaller, perhaps equities-focused) where this development is a significant win; but other firms may feel that it's more straightforward to retain the existing P&L or RPA models.

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