

Takeaways From New FCA Rules On Research Payments

By **Anna Maleva-Otto** (August 16, 2024, 10:26 AM EDT)

The Financial Conduct Authority published final rules on payment optionality for investment research in its policy statement 24/9 in July.[1]

The FCA rules describe this new research payment structure as "joint payments for third-party research and execution services."

In practice, it is based on a commission-sharing arrangement combined with detailed procedural and operational safeguards, including budgeting, valuation and client disclosure obligations, or the CSA option.

The CSA option will be welcome news for U.K. managers who buy investment research from U.S. brokers. Maintaining some of the existing U.S. research relationships has proven challenging since the expiration, in July 2023, of the U.S. Securities and Exchange Commission's no-action relief[2] allowing U.S. broker-dealers to receive separate payments for research without the need to register under the U.S. Investment Advisers Act, as amended.

The CSA option will be equally welcomed by global asset management groups that have had to adopt different research payment structures for their investment teams depending on their location.

Managers whose U.S. clients refuse to pay for research as a separate charge but are open to soft-dollar arrangements meeting the conditions of Section 28(e) of the U.S. Securities and Exchange Act may also wish to consider the CSA option.

MiFID II Unbundling

In 2018, FCA rules applicable to so-called inducements were modified to give effect to the Markets in Financial Instruments Directive, or MiFID II, unbundling reforms.

Research is considered a type of inducement or benefit that the manager receives in connection with the portfolio management services it provides to its clients. The MiFID II reforms required payments for research to be made separately from payments of execution costs.

Their policy objectives were to manage conflicts of interest, improve accountability over costs passed to clients, and improve price transparency for both research and execution services.

Under the current rules, an FCA-regulated manager is required either to pay for research from their own resources — the so-called profit and loss model — or obtain their client's agreement to a separate research charge and pay brokers via a separate research payment account.



Anna Maleva-Otto

2023 saw the publication of the investment research review[3] commissioned by HM Treasury as part of the post-Brexit strive to boost the competitiveness of U.K. markets. The investment research review concluded that the unbundling rules had an adverse impact on the investment research coverage in the U.K., and by extension, a potentially negative impact on the amount of funding available to U.K. companies.

The investment research review's other findings highlighted that unbundling reduced U.K. asset managers' access to global investment research, placing them at a competitive disadvantage internationally.

The final rules in policy statement 24/9 follow an earlier FCA consultation — CP 24/7 —[4] and give effect to some of the recommendations of the investment research review.

Documentation and Procedural Requirements

Investment managers wishing to use the CSA option must comply with the following procedural and client disclosure requirements set out in Conduct of Business Sourcebook 2.3B of the FCA Handbook.

Implement Written Policy

Managers must implement a written policy describing the firm's approach to joint payments addressing governance, decision making and controls over CSA payments.

In most cases, this will necessitate updates to existing research policies designed to comply with the research payment account or profit and loss optionalities. Managers will separately need to ensure that their best execution analysis does not treat the provision of research services as an execution factor.

Stipulate Methodology and Structure

Managers must establish arrangements with their executing brokers that stipulate the methodology for how research costs are calculated and identified separately.

Managers must also establish a structure for the allocation of research payments between the different research providers, including executing brokers and any independent research providers. The separately identifiable research charges may only be used to purchase research.

Although — unlike the CP 24/7 consultation version — the final rules no longer require there to be a written agreement with the executing brokers and any independent research providers setting out the charging methodology and allocation structure, it is likely that these structures and methodology would in practice need to be documented in a CSA-style agreement.

Administration

Administration of the CSA option can be delegated to a third-party administrator.

However, the manager will remain responsible for the operation of such accounts and ensuring that the CSA option does not interfere with the manager's obligations to comply with the FCA rules on inducements.

In particular, the manager must ensure that the reconciliation and reporting for the CSA option are undertaken with an appropriate frequency to allow effective monitoring and risk management from unspent surplus amounts and research provider concentrations of these surplus amounts.

The FCA statements made in policy statement 24/9 imply that the costs of administering a CSA cannot be passed on to a client.

Budgeting and Allocation of Costs

A budget for the purchase of research using the CSA option must be set at least on an annual basis and must be based on the manager's expectations for the need for third-party research.

The research budget must not be linked to the expected volumes or value of transactions. Unlike the consultation draft, managers are not required to set a budget at the level of a client or investment strategy.

Instead, they will have flexibility to adopt the approach they consider appropriate to their investment process, products, services and clients, subject to the overall obligation to ensure that the outcome is fair, such that the relative costs incurred by clients are commensurate with the relative benefits received.

Valuation and Price Benchmarking

At least on an annual basis, managers using the CSA option must assess the value, quality, and their use of research and its contribution to the investment decision-making process.

This assessment must include an element of benchmarking with comparable services to ensure that the amount of research charges passed on to the clients is reasonable.

Client Disclosures

As under the existing research payment account requirements, managers utilizing the CSA option must disclose to their clients:

- The firm's use of the CSA option, including, where relevant, how the use of joint payments may be combined with the research payment account or (profit and loss optionalities);
- The key features of the firm's research policy;
- The expected annual costs to the client based on the expected research budget or the actual costs for the prior period, as appropriate, on an ex ante basis;
- The actual total cost of research incurred by the client, annually, as part of an ex-post reporting on costs and charges; and
- Key information on the types of benefits and services received from research providers — measured by total amounts paid — and the types of research providers, e.g., executing brokers versus independent research providers from whom such services are purchased.

The disclosures must be communicated in a way that is clear, fair and not misleading. If a previously notified research budget is being exceeded, the client should be notified as soon as reasonably practicable, for example, as part of a firm's next periodic reporting on costs and charges.

Other Takeaways From Policy Statement 24/9

Short-term trading commentary and advice linked to trade execution have been added to the list of acceptable minor nonmonetary benefits, which means that U.K. managers are permitted to receive this type of service from their executing brokers without separately paying for it.

This change is the result of the FCA's engagement with market participants, which highlighted challenges facing U.K. asset managers receiving research from U.S. broker-dealers.

The current rules classifying investment research on small and midsize enterprises with a market capitalization below around £200 million (about \$257 million) as minor nonmonetary benefits have been deleted.

Based on the FCA's assessment, this option has had little takeup and, accordingly, was deemed redundant. The provisions classifying corporate access in relation to small and midsize enterprises as an acceptable minor nonmonetary benefit have been retained.

The FCA received feedback on several points that did not directly relate to the policy changes proposed in CP 24/7 and decided not to act on this feedback.

One notable example is that policy statement 24/9 did not address the current status of corporate access services, apart from small and midsize enterprise corporate access and the possibility of using the CSA option to pay for corporate access services.

Other points raised by respondents to CP 24/7 included the rules on research trials, status of fixed income, currencies, and commodities and macro research, and the value-added tax treatment of research payments under the CSA option. The FCA has made no comment on whether these points may be clarified through future consultations or guidance.

Application to U.K. AIFMs and UCITS

The Markets in Financial Instruments Directive II research unbundling rules are applied to non-Markets in Financial Instruments Directive managers, such as alternative investment fund managers and undertakings for the collective investment in transferable securities management companies through the FCA rules in COBS 18, Annex I.

The final rules set out in policy statement 24/9 have not so far been mirrored in corresponding amendments to COBS 18, Annex 1. The FCA intends to consult separately on the required changes to COBS 18 Annex I.

It is likely that the differences between COBS 2.3B and the rules in COBS 18 Annex I will be confined to modifying the client disclosure obligations as appropriate for fund clients.

Action Points to Consider

This CSA option came into effect on Aug. 1 and will exist alongside the research payment account and profit and loss options.

Similar changes to the research unbundling rules are expected to be introduced by EU legislators as part of the MiFID II review. These changes will apply to EU-based investment firms and are expected to offer greater flexibility to global asset manager groups in the future.

The implementation of the CSA option would inevitably require investment managers to negotiate a CSA or similar arrangement with their executing brokers. Although policy statement 24/9 is ostensibly aimed at facilitating access to global investment research, and in particular, U.S. sell-side research, the implementation of the specific safeguards mandated by the FCA rules may not be as straightforward as the industry had hoped.

Many U.S. brokers are accustomed to arrangements in which a defined portion of dealing commission is recorded as part of a client's so-called soft dollar balance. However, that is due, in part, to the payment being characterized as a commission rather than a separate payment for research that could trigger a registration obligation under the U.S. Advisers Act.

Separately, U.K. investment managers should consider the manner in which CSA balances are maintained by U.S. brokers. Unlike with customer cash, U.S. brokers are not required to reserve against soft dollar balances, nor do U.S. brokers typically maintain such balances in a segregated account.

This may require additional negotiation around custody arrangements when engaging U.S. brokers and CSA administrators.

When switching to the CSA option, investment managers will also need to ensure the procedural safeguards are appropriately implemented in written compliance policies, client agreements and periodic client reporting.

Anna Maleva-Otto is a partner at Schulte Roth & Zabel International LLP.

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[1] FCA Policy Statement (PS 24/9): Payment Optionality for Investment Research: <https://www.fca.org.uk/publication/policy/ps24-9.pdf>.

[2] Statement on the Expiration of the SEC Staff No-Action Letter re: MIFID II: <https://www.sec.gov/newsroom/speeches-statements/uyeda-statement-staff-no-action-letter-07-05-2023#:~:text=%5B1%5D%20The%20MiFID%20II%20Relief,smaller%20companies%2C%20among%20other%20considerations>.

[3] UK Investment Research Review, Rachel Kent, 10 July 2023.

[4] FCA Consultation (CP 24/7): Payment Optionality for Investment
Research: <https://www.fca.org.uk/publication/consultation/cp24-7.pdf>.