ALERTS

UK Compliance Update: FCA Rules Will Allow CSA-Style Payments for Research From 1 Aug. 2024

July 30, 2024

The UK Financial Conduct Authority ("FCA") has released the final rules on the Payment Optionality for Investment Research in its PS 24/9.[i] The FCA rules refer to this new research payment structure as "joint payments for third-party research and execution services"; in fact, it is based on a commission sharing arrangement ("CSA Option") combined with detailed procedural and operational safeguards, including budgeting, valuation and client disclosure obligations. Managers who intend to take up the CSA Option will need to ensure the procedural safeguards are appropriately implemented in written compliance policies, CSA agreements or similar, client agreements and periodic client reporting, as appropriate.

The CSA Option will be welcome news for UK managers who buy investment research from US brokers. Maintaining some of the existing US research relationships has proven challenging for UK managers since the expiration, in July 2023, of the SEC no-action relief[ii] allowing US broker-dealers to receive separate payments for research without the need to register under the Investment Advisers Act of 1940, as amended ("Advisers Act"). The CSA Option will be equally welcome by global asset management groups that have had to adopt different research payment structures for their investment teams depending on their location. Managers whose clients refuse to pay for research as a separate charge but are open to soft-dollar or CSA arrangements meeting the conditions of Section 28(e)[iii] may also wish to consider the CSA Option.

Background

In 2018, FCA rules applicable to so-called "inducements" were modified to give effect to MiFID II "unbundling" reforms. Research is considered a type of inducement, or benefit which 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 execution. The policy objectives of the MiFID II reforms 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, FCA-regulated managers are required either to pay for research themselves from their own resources (a so-called, "P&L model") or obtain their clients' agreement to a separate research charge and pay brokers via a separate "Research Payment Account" ("RPA"). 2023 saw the publication of the Investment Research Review ("IRR") commissioned by the HM Treasury as part of the post-Brexit strive to boost the competitiveness of UK markets. The IRR concluded that the unbundling rules had an adverse impact on the investment research coverage in the UK, and by extension, a potentially negative impact on the amount of funding available to UK companies. The IRR's other findings highlighted that unbundling reduced UK asset managers' access to global investment research, placing them at a competitive disadvantage internationally. The final rules in PS 24/9 follow an earlier FCA consultation[iv] ("CP 24/7")) and give effect to some of the recommendations of the IRR.

This CSA Option will exist alongside the RPA and P&L options. In a coordinated move, 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 firms with operations in the EU in the future.

Documentation and Procedural Requirements Applicable to the CSA Option

Managers wishing to use the CSA Option, must comply with the following procedural and client disclosure requirements set out in COBS 2.3B of the FCA Hadbook:

- **Implement a written policy on CSA payments**. Managers must implement a written policy describing the firm's approach to joint payments addressing governance, decision-making and controls over CSA payments (including those detailed below). In most cases, this will necessitate updates to existing research policies designed to comply with the RPA or P&L optionalities. Managers will separately need to ensure that their best execution analysis does not treat provision of research services as an execution factor.

- **Stipulate methodology and structure for research payments**. Managers must establish arrangements with their executing brokers which 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 ("IRPs"). 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 IRPs setting out the chargingmethodology 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 is 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 PS 24/9 imply that the costs of administering a CSA cannot be passed on to a client.

- **Budgeting and allocation of costs among clients**. 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, but instead 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 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 RPA requirements, managers utilising the CSA Option must disclose to their clients (i) the firm's use of the CSA option, including, where relevant, how the use of joint payments may be combined with the RPA or P&L optionalities; (ii) the key features of the firm's research policy; (iii) 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; (iv) the actual total cost of research incurred by the client, annually, as part of an ex post reporting on costs and charges; and (v) 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 vs IRPs) from whom such services are purchased. The disclosures must be communicated in a way which 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 Changes

Other notable rule changes in PS 24/9 are:

- Short-term trading commentary and advice linked to trade execution have been added to the list of acceptable minor non-monetary benefits ("MNMB") which means that UK 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 UK asset managers receiving research from US broker-dealers.

- The current rules classifying investment research on small and medium enterprises with a market capitalisation below £200 million (SMEs) as MNMBs has been deleted. Based on the FCA's assessment, this option has had little take-up and, accordingly, was deemed redundant. The provisions classifying corporate access in relation to SMEs as an acceptable MNMB have been retained.

Application to UK AIFMs

The MIFID II research unbundling rules are applied to non-MIFID managers, such as alternative investment fund managers (AIFMs) and UCITS management companies through the FCA rules in COBS 18 Annex I. The final rules set out in PS 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.

Corporate Access and Other Services Not Covered in PS 24/9

The FCA noted in PS 24/9 that it had received feedback on several points that did not directly relate to the policy changes proposed in CP 24/7. As such, PS 24/9 did not address the current status of corporate access services (apart from SME corporate access above) 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 FICCs and macro research, and the VAT 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.

US Market Considerations

While the CSA Option should prove useful for UK Managers who buy investment research from US brokers, some potential issues will need to considered.

For instance, certain US brokers do not identify an explicit price for their proprietary research; rather, the manager receiving such proprietary research makes an independent assessment of the value of such

research in relation to the commissions paid. As the CSA Option contemplates that research being obtained will have an explicit price, certain proprietary research may not be available under the CSA Option absent a change in brokers' practices.

Further, while the UK Manager's research budget may not be linked to expected trade volumes, funding may be achieved through payments linked to executions. Although many US brokers are accustomed to arrangements in which a defined portion of a commission is recorded as part of a manager's "soft dollar balance", that is due, in part, to the payment being characterized as a commission rather than a separate payment that could trigger a registration obligation under the Advisers Act. US brokers will need to assess the nature of research payments made under the CSA Option to ensure they do not raise registration concerns under the Advisers Act.

Separately, UK managers should consider the manner in which CSA balances are maintained by US brokers. Unlike customer cash, US brokers are not required to reserve against soft dollar balances, nor do US brokers necessarily maintain such balances in a segregated account. This may require additional negotiation around custody arrangements when engaging US brokers and CSA administrators.

Authored by *Anna Maleva Otto* and *William J. Barbera*.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[i] FCA Policy Statement (PS 24/9): Payment Optionality for Investment Research

[ii] Statement on the Expiration of the SEC Staff No-Action Letter re: MIFID II

[iii] Section 28(3) of the Securities and Exchange Act 1934.

[iv] FCA Consultation (CP 24/7): Payment Optionality for Investment Research

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Related People

Anna Maleva-Otto

Partner

London

William Barbera

Partner

New York

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