

October 19, 2017

MiFID II: What is new for buy side? Research Unbundling

Topic 5, Update 1

Newly inserted text is underlined.

What is new here?

New MiFID II conflicts of interest and inducements rules require Investment Managers¹ to pay for research on an unbundled basis, i.e. separate from execution fees and commissions. This means that research must be paid for either by direct payments by the Investment Manager out of its own resources or payments from a separate client funded Research Payment Account or “RPA”. The rule on inducements is contained in Articles 24(7)(b) and (8), MiFID II, supplemented by the [Delegated Directive](#) dated April 7, 2016 and guidance from national regulators.

Article 13 of the Delegated Directive states that investment firms providing execution services are required to separately identify their charge for these services, such that the charge reflects only the cost of executing the transaction. Further, each other benefit or service provided by the same investment firm to other investment firms established in the union shall be subject to a separately identifiable charge. Firms providing services other than execution need to ensure that the supply of and the charges for such additional benefits and services is independent of the level of payment for execution services.

What constitutes research for the purposes of unbundling?

The definition of research for the purposes of inducement rules can be interpreted broadly. It will likely capture all material coming out of the Research Department and could also capture some of the more substantive material emanating from banks’ Sales & Trading departments. Labelling alone won’t render material out of scope; the test is on the content. Research includes both materials and services and therefore, will include written product, models, calls, meetings and other services.

‘Research material and services’ has a specific meaning in relation to the rule on inducements. This is different from ‘investment research’ (also defined in MiFID II) and ‘Investment recommendations’ under MAD/MAR, both defined separately in the respective legislations.

¹ The [Financial Conduct Authority \(FCA\)](#) has extended the application of these rules to Collective Portfolio Managers including UCITS management companies, full scope UK AIFMs, incoming EEA AIFM branches, small authorised UK AIFMs and residual Collective Investment Scheme (CIS) operators in the UK. On the other hand, The [Autorité des marchés financiers \(AMF\)](#) in its [policy statement](#) has not included Collective Portfolio Managers for MiFID II Research related inducement rules.



However, these are not mutually exclusive and material may fall within one or more of these categories.

Materials and services that qualify as minor non-monetary benefits are excluded from the inducement rule and are not required to be paid for separately.

What are ESMA's views on macro-economic research?

ESMA, in its Q&A on Investor Protection topics, has provided the following criteria to determine whether macro-economic related material can be considered 'research' or not:

1. The material or service must concern one or several financial instruments or other assets, or current or potential issuers of financial instruments, or be closely related to a specific sector or market such that it informs views on financial instruments, assets or issuers within that sector or market. And,
2. This material or service explicitly or implicitly recommends or suggests an investment strategy and provide a substantiated opinion as to the present or future value or price of such instruments or assets, or contains analysis and original insights and reaches conclusions based on new or existing information that could be used to inform an investment strategy and be relevant and capable of adding value to the investment firm's decisions on behalf of clients being charged for that research.

ESMA stated that most macro-economic analysis should be considered to explicitly or implicitly recommend or suggests an investment strategy, unless it can be concluded that the analysis is so generic that it falls outside the definition.

Based on the above criteria, if investment firms believe that material/service is classifiable as 'research', they have the option of buying it per Article 13 of the Delegated Directive. ESMA further clarify that all material that cannot be classified as 'research' does not automatically become classifiable as 'minor non-monetary benefit'. If macro-economic analysis is substantive or involves allocation of valuable resources by the provider to the recipient firm, or is deemed to have material value by the recipient firm, it will not constitute 'minor non-monetary benefit'. For such material/service, investment firms have to make a commercial decision to either pay for it from their own resources or not accept it.

Further, ESMA stated that macro-economic related material could be classified as 'minor non-monetary benefit' if the provider makes such material openly available to all interested investment firms at the same time or to the general public; for example by putting it up on the website. This does not necessarily mean that all openly/freely available material (that is not related to macro-economic analysis) can be considered a 'minor non-monetary benefit'.

How are Investment Managers expected to comply with this rule?

The Delegated Directive mandates Investment Managers to agree with their clients *ex ante* in their Investment Management Agreement or General Terms of Business - a research budget, a research charge² and the frequency with which the specific research charge will be deducted from the resources of the client over the year. Investment Managers' clients may then choose which mechanism they wish to use to pay for 3rd party research.

The introduction of this rule means that Investment Managers have to modify their current model for procuring 3rd party research. Irrespective of whether Investment Managers pay out of their own resources or use client funds, procuring 3rd party research under MiFID II is likely to involve enhanced due diligence and increased administrative burden on the Investment Managers' part, e.g. assessing a research budget, establishing internal governance procedures to assess the

² A Research budget may be split up into multiple 'Research charges'. The total amount of Research charges received may not exceed the Research Budget.

quality of research, implementing processes and controls to ensure that research is paid for appropriately, administration of research access logons and making timely disclosures to clients.

What are the MiFID II compliant payment mechanisms for research?

There are three mechanisms of payment for research under MiFID II:

- Payment via transaction commissions, where commission is split between execution and research (Commission Sharing arrangement or 'CSA' model)
- Payment via a direct charge to client funds (Direct Charging model)
- Payment from the Investment Manager's operational expenses (OpEx model)

What should Investment Managers know about research budgets?

- ESMA in their [Q&A](#) have allowed Investment Managers to set research budgets at a strategy level provided that client portfolios have similar mandates and objectives. Both the FCA and the AMF in their respective policy statements have shared this view.
- The principles underlying this rule are that all clients should be treated fairly and their research costs should not be tied to the volumes they trade. Investment Managers need to ensure that they identify measurable criteria before they receive research (for example, linking research budgets to the percentage of assets under management).
- Investment Managers also need to ensure that clients who come into the fund at a particular point in time in the year are not being cross-subsidized by those in the fund already who paid up front at the beginning of the year. For example, if a client comes in to the fund on January 1st and leaves on March 5th, it needs to be seen that it has paid for research only for that period and not the full year. Continuous in and out-flow of funds and a changing client base may make it very challenging to apply such a charging mechanism within a CSA style setup.
- Investment Managers are required to assess and notify research budgets to their clients. The FCA has proposed that firms need to make budget notifications at least annually. On the other hand, the AMF stated that they may allow multi-year budgets where necessitated and justified by clients' interests. In addition, clients will need to be informed how much was actually spent on 3rd party research.
- At the end of the year if there is a surplus in the RPA, then the Investment Manager is required to establish a process to either rebate the surplus back to the client or adjust it against future research costs- whatever the firm chooses to do, clients have to be notified.
- Any increase in the research budget will have to be notified to clients clearly. Where clients do not expressly object to the proposed increases in the budget within the agreed period of time, they will be deemed to have accepted it.

What is the status of CSAs in a MiFID II world?

MiFID II allows Investment Managers to collect research charges from clients alongside transactions commissions³. Both the AMF and the FCA have stated that CSAs may still be used by firms, albeit with some modifications and supervision by investment firms in order to comply with the MiFID II inducements rules.

The FCA in this regard has indicated to buy side firms that it expects them to operate an RPA to which their CSA brokers should transfer the research funds within 30 calendar days of collecting them. Other regulators, including the AMF have not specified a timeframe to sweep the collected research charge to a separate RPA.

What should Investment Managers do if they receive unsolicited research?

ESMA⁴ have mandated that Investment Managers may only receive research in compliance with the inducement rule. Where they receive research without requesting it, they need to have policies and systems to assess the nature and scale of the content provided and pay for it (if it's not a minor non- monetary benefit) if they wish to retain it. Investment Managers run the risk of being non-

³ Article 13(3), [Delegated Directive](#).

⁴ ESMA Q&A, available [here](#)

compliant where they receive research for free (even if in the testing/ trial phase of a provider) without making an assessment.

If Investment Managers do not want to accept unsolicited research, they need to take reasonable steps to ensure that they either cease receiving such content or avoid benefitting from it by blocking or filtering senders or content as practicable. They may also request providers to abstain from providing unsolicited research to them for free. Depending on the nature and complexity of their business, they should take steps to train their staff and ensure that their personnel understand the firm's policies towards such research. They are advised to treat research from 3rd country research providers to whom MiFID II doesn't apply, in the same way.

The AMF and the FCA have advised their buy side communities similarly.

[Can Investment Managers trial 3rd party research before paying?](#)

For trial and testing periods, both the FCA and the AMF have stated that they will allow investment firm to receive and provide research for free during trial periods, provided they strictly follow certain rules. They have stated that a limited trial period for research service will be construed as an acceptable minor non-monetary benefit; provided that the firm:

- Only receives a trial of upto 3 months;
- Is not required to provide any monetary or non-monetary consideration to the provider for the duration of the trial; and
- Does not accept a new trial with the same provider within a 12 month period from the date on which a previous trial or existing research agreement ceased.

The FCA has further advised that investment firms receiving research during trial periods must comply with other requirements regarding acceptable minor non-monetary benefits and maintain records to demonstrate that the above required conditions were adhered to. The AMF has stipulated that a trial period may only be offered prior to the decision to conclude a contract or an agreement between the parties. The AMF further advised that parties must agree in advance the content of the services offered during the trial period. At the end of the trial period, the recipient firm must cease to accept research from the provider or establish relevant research agreement and payment terms with them.

Previously published documents in this series may be accessed here:

- [An Overview of MiFID II](#)
- [Topic 1, Update 1, MiFID II](#) – Trade and Transaction Reporting
- [Topic 2, Update 1, MiFID II](#) – Systematic Internalisers, Trading Obligation and Matched Principal Trading
- [Topic 3 MiFID II](#) – Best Execution
- [Topic 4, Update 1, MiFID II](#) – Direct Electronic Access, Algorithmic Trading and Self-Assessment
- [Topic 5 MiFID II](#) – Research Unbundling
- [Topic 6, Update 1, MiFID II](#) – Impact on Non Equities
- [Topic 7, MiFID II](#) – Extraterritoriality
- [Briefing Note – Transparency for Equity Derivatives](#)
- [Briefing Note – Changing Landscape of Equity Trading](#)
- [Briefing Note – Definition of Systematic Internalisers and Industry Feedback to EC Consultation](#)
- [Briefing Note – Trading Capacities](#)
- [Directory of Documents](#)

Global Market Structure- EMEA

Stephen McGoldrick
stephen.mcgoldrick@db.com
+44(20)754-75552

Gargi Purandare
gargi.purandare@db.com
+44(20)754-70168

Disclaimer

IMPORTANT: This electronic communication has been prepared by members of the Market Structure Team within the Equity Sales and Trading department of the Global Markets Division of Deutsche Bank. References to “we” or “Deutsche Bank” are in reference to the Market Structure Team. The Market Structure Team provides commentary related to trading and market structure and is not part of the Research department of Deutsche Bank. The views expressed in this electronic communication may differ from those expressed by other departments within Deutsche Bank, including the Research department.

Quantitative models, processes and parameters are subject to amendment, modification, adjustment and correction at Deutsche Bank’s discretion, and may incorporate Deutsche Bank’s qualitative judgment. Deutsche Bank will from time-to-time run or update such models at its discretion. Clients are responsible for making their own determination as to the suitability and appropriateness of such models for their investment objectives.

This document is intended for information purposes only and does not create any legally binding obligations on the part of Deutsche Bank AG and/or its affiliates (“DB”). Without limitation, this document does not constitute an offer, an invitation to offer or a recommendation to enter into any transaction. It does not constitute a recommendation or endorsement by DB of any investment, trading strategy or algorithm and should not be relied upon by you to make a determination as to whether or not to invest or to use any strategy or algorithm.

When making an investment decision, you should rely solely on any specific final documentation relating to a transaction and not the summary contained herein. DB is not acting as your legal, financial, tax or accounting adviser or in any other fiduciary capacity with respect to any proposed transaction mentioned herein. This document does not constitute the provision of investment advice and is not intended to do so, but is intended to be general information. Any product(s) or proposed transaction(s) mentioned herein may not be appropriate for all investors and before entering into any transaction you should take steps to ensure that you fully understand the transaction and have made an independent assessment of the appropriateness of the transaction in the light of your own objectives, needs and circumstances, including the possible risks and benefits of entering into such transaction. For general information regarding the nature and risks of the proposed transaction and types of financial instruments please go to www.globalmarkets.db.com/riskdisclosures. YOU SHOULD ALSO CONSIDER SEEKING ADVICE FROM YOUR OWN ADVISERS IN MAKING ANY ASSESSMENT ON THE BASIS OF THIS DOCUMENT. If you decide to enter into a transaction with DB, you do so in reliance on your own judgment. The information contained in this document is based on material we believe to be reliable; however, we do not represent that it is accurate, current, complete, or error free. Assumptions, estimates and opinions contained in this document constitute our judgment as of the date of the document and are subject to change without notice. Any projections are based on a number of assumptions as to market conditions and there can be no guarantee that any projected results will be achieved. Past performance does not guarantee or predict future results. This material was prepared by a Sales or Trading function within DB, and was not produced, reviewed or edited by the Research Department. Any opinions expressed herein may differ from the opinions expressed by other DB departments including the Research Department. Sales and Trading functions are subject to additional potential conflicts of interest which the Research Department does not face. DB may engage in transactions in a manner inconsistent with the views discussed herein. DB trades or may trade as principal in the instruments (or related derivatives), and may have proprietary positions in the instruments (or related derivatives) discussed herein. DB may make a market in the instruments (or related derivatives) discussed herein. Sales and Trading personnel are compensated in part based on the volume of transactions effected by them. DB seeks to transact business on an arm’s length basis with sophisticated investors capable of independently evaluating the merits and risks of each transaction, with investors who make their own decisions regarding those transactions. The distribution of this document and availability of these products and services in certain jurisdictions may be restricted by law. You may not distribute this document, in whole or in part, without our express written permission. DB SPECIFICALLY DISCLAIMS ALL LIABILITY FOR ANY DIRECT, INDIRECT, CONSEQUENTIAL OR OTHER LOSSES OR DAMAGES INCLUDING LOSS OF PROFITS INCURRED BY YOU OR ANY THIRD

PARTY THAT MAY ARISE FROM ANY RELIANCE ON THIS DOCUMENT OR FOR THE RELIABILITY, ACCURACY, COMPLETENESS OR TIMELINESS THEREOF.

Deutsche Bank AG (“the Bank”) is a joint stock corporation incorporated with limited liability in the Federal Republic of Germany. It is registered in the Commercial Register of the District Court, Frankfurt am Main under number HRB 30 000.

The Bank is authorized under German Banking Law (competent authorities: European Central Bank and the BaFin, Germany’s Federal Financial Supervisory Authority) and, in the United Kingdom, by the Prudential Regulation Authority. It is subject to supervision by the European Central Bank and by the BaFin, and is subject to limited regulation in the United Kingdom by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of the Bank’s authorization and regulation by the Prudential Regulation Authority, and its regulation by the Financial Conduct Authority, are available from the Bank on request.

The Bank is registered as a foreign company in the register of companies for England and Wales (registration number FC007615).

Under its European Passport, the Bank carries on banking and investment services in the United Kingdom through Deutsche Bank AG, London Branch (“London Branch”) and is also authorized to provide such services into the United Kingdom from Germany and from its other EEA branches.

Deutsche Bank AG, London Branch is registered as a branch in the register of companies for England and Wales (registration number BR000005). Its registered address is Winchester House, 1 Great Winchester Street, London EC2N 2DB.

In addition to its above authorisations, the Bank is authorised by the Financial Conduct Authority to carry on investment services in precious metals.

London Branch is listed as a member firm of the London Stock Exchange.