

## Briefing note

### ***ESMA Q&A on MiFID II inducements rules (research)*** **(Latest update by ESMA: 4 April 2017)**

#### Introduction

The European Securities and Markets Authority (ESMA) has issued Q&A for research (as inducements) to help firms and Member States implement the Markets in Financial Instruments Directive II (MiFID II) rules. ESMA's Q&As have been issued on 10 October 2016, 16 December 2016 and 4 April 2017. They form part of a broader release of [Q&As on investor protection](#) (the research questions are covered on pages 41-52).

The Q&A provides guidance on how firms should interpret the research provisions in MiFID II and delegated legislation. Question 1 was part of the October release, Questions 2-6 were added in 16 December 2016 and Questions 7-11 were added in the latest update, on 4 April 2017. ESMA has indicated that further updates may be released before the application deadline of MiFID II which is 3 January 2018.

#### Executive Summary

The elements covered in the 10 October 2016 and 16 December 2016 publications (Questions 1-6) are:

- Setting of research budgets: ESMA considers that a budget can be set for a group of client portfolios or accounts where the firm has established a similar need for third party research in respect of the investment services rendered to its clients.
- Legal status of money held in a research payment account (RPA): ESMA points out that an RPA must be funded by a research charge to the client and that due to its nature as a charge, the funds belong to the firm.
- Dealing with unrequested research provided free of charge: ESMA stresses that it is not acceptable for firms to receive research for free where no assessment has been made under the inducements rules or there is no payment arrangement in place. ESMA provides several examples of what it considers reasonable steps which a firm should take to avoid receiving free unrequested research.
- Accepting research from third country providers not subject to MiFID II: ESMA clarifies that firms subject to MiFID II inducement rules must comply with these requirements irrespective of the status or geographical location of the research provider.
- Receiving research from another group entity: ESMA clarifies that the MiFID inducements rules apply in the same manner irrespective of being part of the same group or not.
- When are materials considered minor non-monetary benefits rather than research: ESMA points to recital 29 of the MiFID II Delegated Directive (C(2016)2031) which says that "non-substantive material or services consisting of short term market commentary on the latest economic statistics or company results" may be treated as minor non-monetary benefits.

The main elements of the 4 April 2017 publication (Questions 7-11) are:

- Corporate Access: ESMA does not consider that arranging meetings is research because it does not "explicitly or implicitly recommend or suggest an investment strategy and provide a substantiated opinion as to the present or future value or price of such instruments or assets".
- Macro-economic analysis: if macro-economic analysis explicitly or implicitly suggests an investment strategy, macro-economic analysis is considered research. Only macro-economic analysis openly available and generic in nature could be considered a minor non-monetary benefit.
- FICC (Fixed-income, currencies and commodities) research: Like equity research, FICC or other asset analysis should be either considered research or a minor non-monetary benefit – in other words there is no differential treatment for FICC.
- Allocation of research budgets: Investment firm research budgets need to be built on ex-ante estimates of research spending. There should also be: (1) a clear audit trail of the payments made to research providers; (2) controls over how amounts paid are determined based on the quality criteria established by the firm; and (3) well documented decisions to minimise conflicts of interest.
- Disclosure of research costs to end-clients: At least the budget amount per strategy and the estimated research charge should be provided by the asset manager to its end-clients, both as a percentage and a cash amount.

### Summary of Answers

#### Setting research budgets for multiple clients when using RPAs (Question 1)

- ESMA considers that a budget can be set for a group of client portfolios or accounts where the firm has established a similar need for third party research in respect of the investment services rendered to its clients.
- ESMA points out that this would allow firms to set a research budget at a desk or investment strategy level if they can evidence that these have sufficiently similar mandates and investment objectives that investment decisions are informed by the same research inputs.
- ESMA expects firms to describe their approach in a written research policy provided to clients and that their approach is consistent with using the budget in the best interests of its clients.
- However, firms are still required to identify a specific research charge for individual clients to fund the RPA, even where the budget is set for several portfolios. Firms will need to have a transparent method for making a fair allocation of costs e.g. the firm pro-rating the cost of research across all client accounts based on the value of each client's portfolio.
- ESMA stresses that firms should not set a budget for a group of client portfolios that do not share sufficiently similar investment objectives and research needs.

#### Legal status of money held in a RPA (Question 2)

- ESMA refers to Article 13 of the MiFID II Delegated Directive in concluding that an RPA must be funded by a research charge to the client.

- ESMA points out that by nature of this deduction as a charge, means that the funds belong to the firm, however, these funds should be managed in an RPA controlled by the investment firm and it should be used specifically for purchasing external research.
- ESMA encourages firms to align as much as possible the timing of the charges paid by the client to the firm and the expenditure paid to the research provider.
- ESMA clarifies that the obligation on investment firms to rebate surplus funds if they underspend the original research budget does not alter the status of the RPA money.
- The investment firm must be satisfied that through any outsourced agreements it continues to retain full discretion and control over the use of the account.
- The money should be ring-fenced and clearly separated from other funds of the RPA Administrator, such that they remain legally owed to the investment firm.
- The third-party provider should have no right of set-off over the money or be entitled to use it as collateral or otherwise for their own benefit.

#### Dealing with unrequested research provided free of charge (Question 3)

- ESMA stresses that it is not acceptable for firms to receive research for free where no assessment has been made under the inducements rules or there is no payment arrangement in place that complies with Article 13 of the MiFID II Delegated Directive.
- Where a firm does not want to accept research material, they should take reasonable steps to cease receiving it or avoid benefitting from its content. ESMA provided the following examples:
  - Automatically blocking or filtering certain senders/materials;
  - Requesting a provider to stop providing research;
  - Using the compliance function of the firm to monitor, assess and determine whether the material can be accepted before it reaches those parts of the firm that will make use of it;
  - Provide adequate training to staff to ensure they understand the inducements obligations and the firm's approach to receiving research;
  - Having procedures whereby staff report to compliance or senior management any cases of unsolicited research being provided by a third party where no payment agreement is in place.
- Where the provider of research is a firm which also provides execution services under MiFID II, the provision of unsolicited or free research would not meet the obligations on them to price services separately. These firms should have systems and controls to enable them to cease providing unsolicited research.

#### Accepting research from third country providers not subject to MiFID II (Question 4)

- ESMA points out that EU/EEA firms subject to MiFID II inducement rules must comply with these requirements (Article 24, paragraphs (7), (8) and (9), and the relevant level two provisions) irrespective of the status or geographical location of the research provider.
- Firms should therefore treat research from a third country provider in the same way as any other third party benefits.

#### Receiving research from another group entity (Question 5)

- ESMA clarifies that the MiFID inducements rules apply in the same manner irrespective of being part of the same group or not.
- ESMA points out that in the case that firms accept to receive research from other firms in the same group, they should pay particular attention to the following points:
  - Potential conflicts of interests and the obligation to assess the quality of research and keep appropriate controls and oversight over the amounts paid with reference to the quality;
  - the requirement to ensure a research budget is used and managed in the best interests of their clients and that the costs of research are allocated fairly between client portfolios.
  - The commercial preference of a firm to operate as part of a global business model does not override their obligations under Article 13 if using an RPA.

#### What is considered minor non-monetary benefits as opposed to research (Question 6)

- ESMA refers to the definition of minor non-monetary benefits which is provided in Article 24 (8) of MiFID II Level 1 Directive and to specific items provided for in Article 12(3) and Recital 29 of the MiFID II Delegated Directive, which state that: “non-substantive material or services consisting of short term market commentary on the latest economic statistics or company results” may be treated as minor non-monetary benefits.
- Firms need to assess whether the material is substantive or not based on content and not the qualification given by the provider.
- Firms also need to assess whether they are “reasonable and proportionate and of such a scale that they are that they are unlikely to influence the firm’s behaviour in any way that is detrimental to the interest of the relevant client”.
- ESMA clarifies that a detailed research report or conversation with a research analyst, which in content meets the nature of research described in Recital 28, cannot be considered as a minor non-monetary benefit due to it being labelled as such by a provider or because such material is provided through a dealing desk rather than a research department. By contrast, short market updates with limited commentary or opinion may be capable of being considered as information that is a minor non-monetary.
- ESMA points out that the restriction on inducements should also not prevent communications in the context of seeking market information to immediately execute an order between traders, for example on available liquidity or recently traded prices, which should be considered as part of the execution service.
- ESMA notes that material repeating or summarising public news stories or public statements from corporate issuers could also be considered as information that constitutes a minor non-monetary benefit.
- Another exemption is for pre-deal material directly relating to a new capital raising event by an issuer, which is produced by a third party such as another investment firm who is placing/underwriting the issue – provided that the nature of the material is made clear and it is available at the same time to any prospective investor.
- ESMA clarifies, referring to Recital 30, that “any non-monetary benefit that involves a third party allocating valuable resources to the investment firm shall not be considered as minor

and shall be judged to impair compliance with the investment firm's duty to act in their client's best interest."

#### Corporate Access (Question 7)

- ESMA refers to a definition of research for RPA purposes in Recital 28 of the MiFID II Delegated Directive in concluding that corporate access visits do not appear to be "research" and should be considered a discrete service.
- ESMA points out that this does not preclude corporate access visits being paid for from a Research Payments Account (RPA), but general research payments should not subsidise such a service.
- ESMA expects investment firms to carefully assess whether corporate access services such as field trips, conferences and individual meetings involving a corporate issuer and facilitated by an investment firm are material benefits, or alternatively could qualify as an acceptable minor non-monetary benefit.
- ESMA notes that an investment firm can also treat corporate access as a commercial service and pay for it appropriately from its own resources. In such cases, it is important that the provider prices services at commercial levels and access itself is not linked to or dependent on payments for research or execution services where the provider offers these other MiFID services.
- ESMA also notes that the investment firms wishing to meet with a corporate issuer individually has the option to approach them directly and/or pay for a third party corporate access service provider to facilitate meetings that does not provide other MiFID investment services.

#### Macro-economic research (Question 8)

- ESMA draws out two criteria for macro-economic research to fulfil to be considered research, drawn from Recital 28 of the Delegated Directive. These two criteria must both be met:
  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. The 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 thinks that most macro-economic research is likely to suggest an investment strategy, but accepts that some macro-economic research is sufficiently general to fall outside the definition.
- However, if macro-economic analysis is not considered as research according to these criteria, recipients still cannot automatically classify it as a minor non-monetary benefit, because it may be considered substantive or to have material value.

- An important exception is where a provider makes macro-economic-related material openly available at the same time to any investment firms wishing to receive it or to the public, for example on a website. Material made available in this way could be justified as a minor non-monetary benefit – representing “information ... relating to a financial instrument or investment service” that is “generic in nature”.
- Because macro-economic research is often generic it is usually relevant across a variety of strategies and asset allocation decisions, and therefore ESMA thinks that firms may be able to more easily justify paying for it on a subscription basis and allocating costs more broadly across many of its clients’ portfolios and accounts.

#### FICC research (Question 9)

- ESMA notes that there is no carve-out from the research rules for FICC markets.
- ESMA acknowledges that the lack of explicit execution commission arrangements in FICC markets makes it difficult for firms to pay for FICC research separately from execution costs. But ESMA thinks that firms may simply choose to pay for such research out of their own resources or by using a RPA funded by a direct charge to the client.
- Given commonalities between FICC and macro research, ESMA believes that firms can use a subscription model to pay for FICC research (as per ESMA’s answer to Question 8). But firms must document how they arrive at their pricing structure to avoid the possibility that the research acts as an inducement (i.e. the subscription should not be extremely heavily discounted, for instance).
- As per macro-economic research, FICC research can be made available to the public by providers, or firms may receive FICC research if it has been commissioned and paid for by a corporate issuer or a potential issuer. In both cases the output would be classified as a minor non-monetary benefit.
- ESMA acknowledges that some FICC research may lack enough substantive analysis and instead represent information about financial instruments or short-term market commentary that qualifies as a minor non-monetary benefit.

#### Allocation of research budgets (Question 10)

- ESMA reminds readers that MiFID requires firms to set out in their research policy the criteria against which the quality of the research material they purchase should be assessed. The research policy also needs to articulate how the research inputs can contribute to better investment decisions and explain how the related costs can be allocated in a manner that is fair to the various clients’ portfolios.
- ESMA particularly draws attention to the importance of fair allocation of costs to clients where firms purchase research centrally and make it widely available within the firm.
- Fair allocation could involve apportioning costs according to the expected relevance of research to particular investment strategies or the level of use by individuals or teams that manage or advise on certain portfolios or accounts.
- ESMA stresses that the research budget should be an ex-ante estimate of forecast expenditure for research costs that can be charged to portfolios with similar strategies under management. This, in turn, will require that a budget is sufficiently granular to be able to be pre-apportioned by portfolio or client.

- ESMA expects portfolio managers to have robust systems in place to ensure that decisions on the procurement of research are clearly documented, and are taken separately and distinctly from decisions on the choice of brokerage and execution services subject to relevant best-execution requirements. Portfolio managers should be particularly aware of conflicts of interest risks when purchasing research alongside execution services
- In ESMA's view, a firm should have a clear methodology to establish what they expect to pay providers for research before they receive and consume services. One way of doing it is for a firm to set measurable ex ante criteria as to how it will value the types, level and quality of service.
- In order to assess the value of research, ESMA says that firms may, for example, have their own internal 'rate cards' or thresholds to adjust what they will pay individual providers for specified service levels.
- ESMA considers that the regular ex-post assessment contributes to evaluate the quality of the research they have purchased and to inform their future procurement decisions and payment levels.
- ESMA acknowledges that firms have scope to negotiate research prices with suppliers. Internal records of investment firms procuring research should demonstrate how they have reached their assessment of value and the actual price they secure for specific research services. ESMA stresses that there should be no correlation between the transaction volumes executed by a broker on behalf of a portfolio manager and any 'discount' applied to the research material offered to the same portfolio manager.

#### Disclosure of research costs to end-clients (Question 11)

- Before providing an investment service, investment firms intending to use an RPA to pay for investment research should provide clients with two separate pieces of information: (i) the amount that the investment firm has budgeted for research; and (ii) the estimated amount that can be expected to be paid out of the assets of the individual client.
- In relation to the second aspect, ESMA states that the estimate should be considered in light of the wider MiFID II costs and charges provisions. Therefore, ESMA considers that the estimated client research charge should be presented as a single estimate figure, and disclosed in both a percentage (or basis points) format and as a cash amount.
- ESMA allows that if a firm wishes to do so to provide a degree of certainty to investors, it can present (ii) as a maximum figure where they guarantee to their clients they will not pay more than that predetermined amount. However, figures presented as a range are not acceptable.