

# Ahead of the curve: Proposed changes to investment research rules

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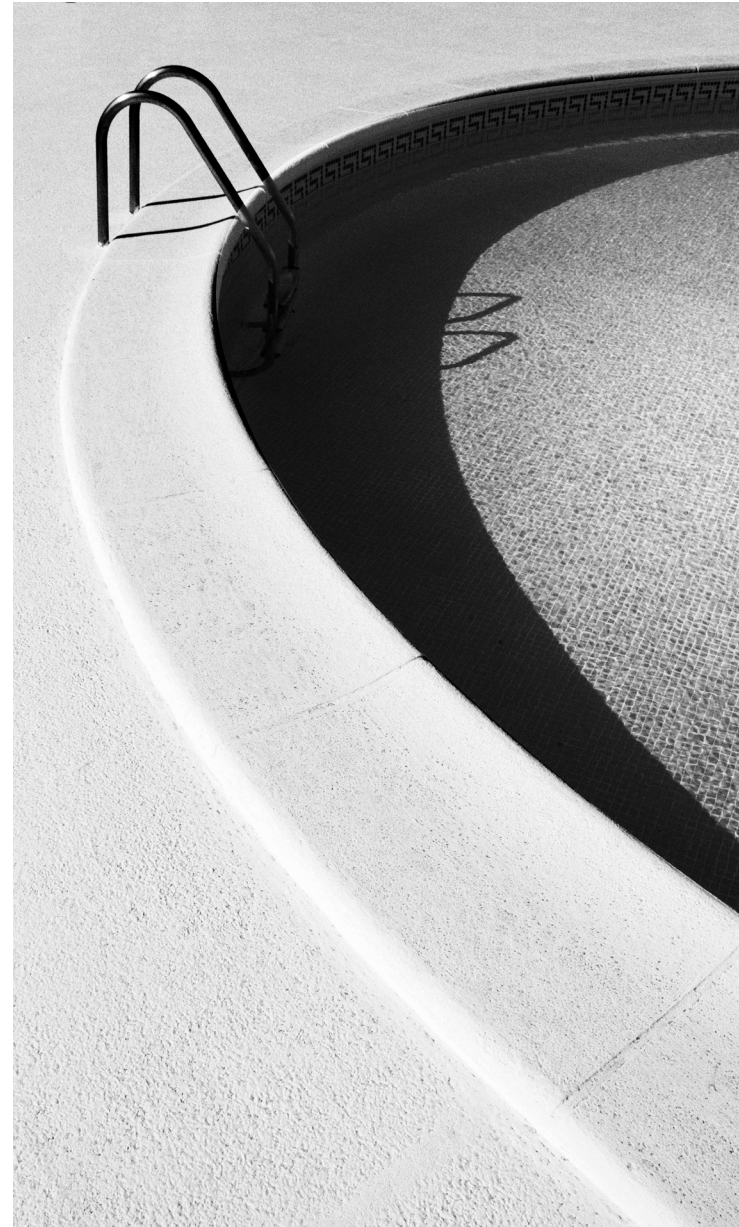
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11 July 2024



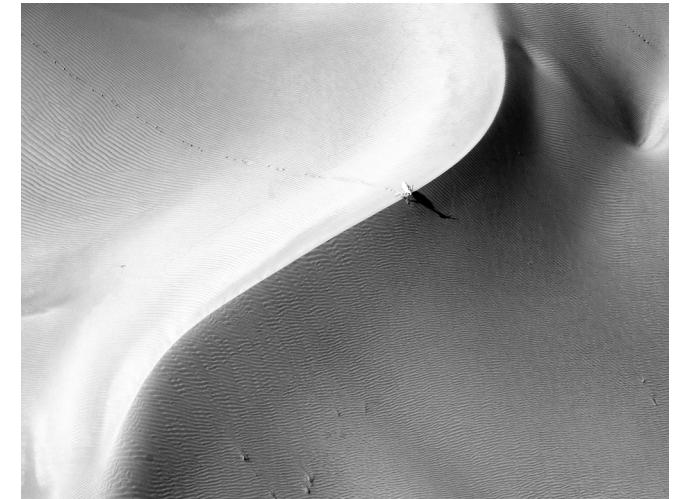
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# Proposed changes to investment research rules

## Agenda

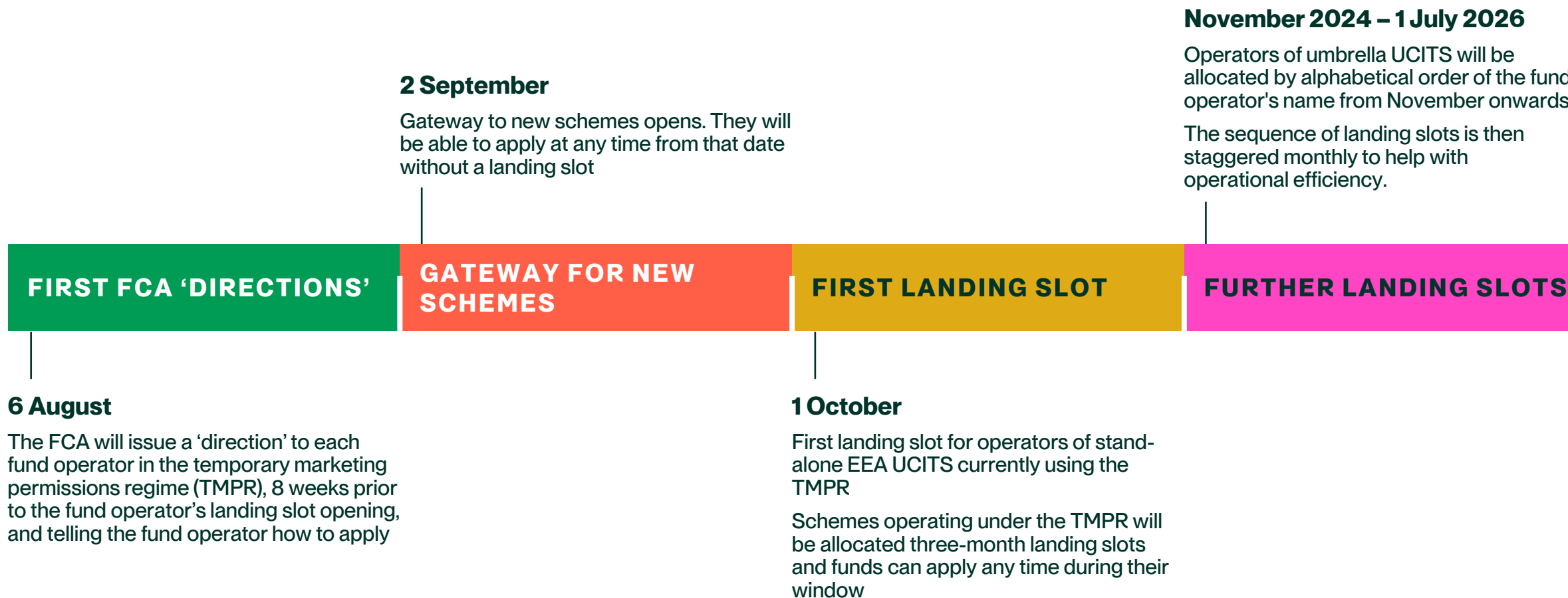
- 01 But first, the news.....
- 02 Background to research reforms
- 03 Research reforms and payment optionality
- 04 US impacts



The news....



# Overseas Funds Regime



# Sustainability disclosure requirements and investment labelling regime



## INVESTMENT LABELS

Labels can be displayed from 31 July

Firms must meet the naming and marketing rules from 2 December








## NOTIFYING THE FCA

Firms must notify the FCA when using an investment label through the form available on Connect

The FCA does not approve labels, but firms are still required to notify when they use, revise or stop using a label

# Accelerated Settlement

	<b>OPERATIONAL</b> Deadlines/Processes; Corporate actions; Infrastructure resilience; Static data
	<b>ALIGNMENT</b> Scope; EU/US alignment
	<b>TRADING AND LIQUIDITY</b> Stocklending; Repo; Trading; FX; Funding
	<b>LESSONS FROM THE US</b>
	<b>LEGAL AND REGULATORY</b>

## TGT+1

27 June: Internal submission of workstream recommendations

End September: Interim Report with Recommendations and short consultation

End December: Final Report with Recommendations

## SETTLEMENT EFFICIENCY

BoE Sec Lending Committee Report recommends:

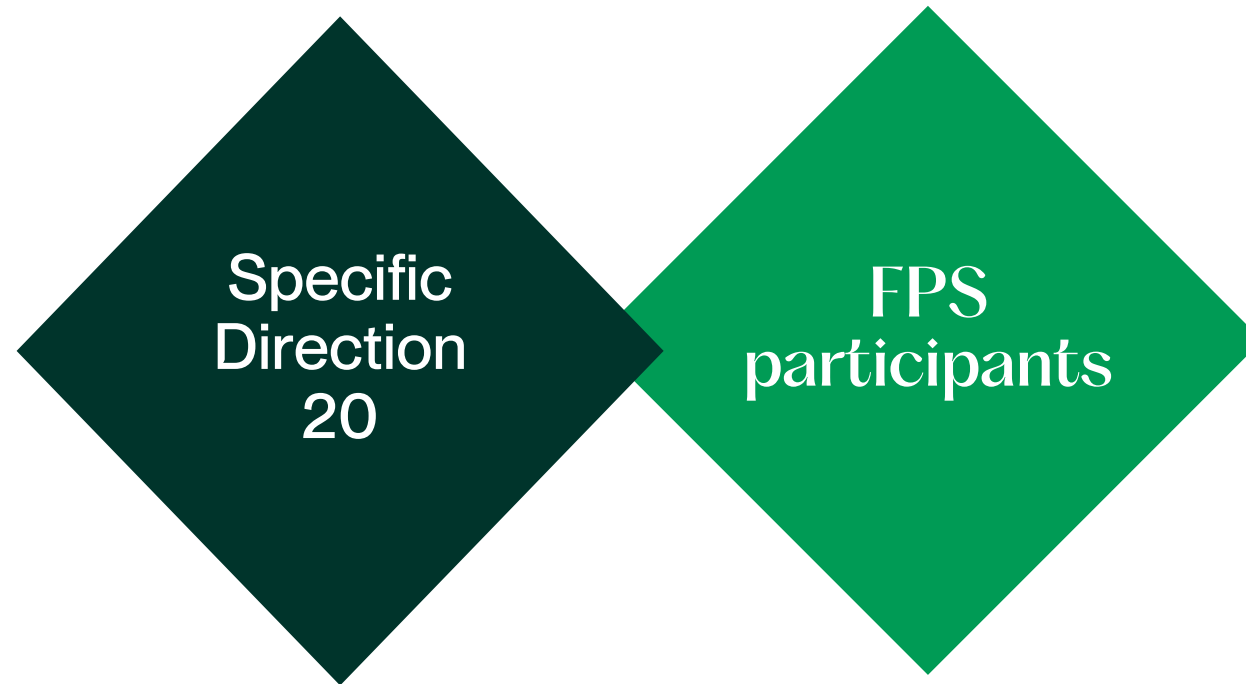
- (i) enhanced static data management;
- (ii) real-time communication of position-impacting data between parties
- (iii) consistent trade and lifecycle event instruction discipline
- (iv) increased investment in pre and post trade automation
- (v) a market-wide adoption of industry best practices

**‘Insurers have now everything they need to use the Solvency UK reforms to support their plans for UK productive investments.’**

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**GARETH TRURAN, EXECUTIVE DIRECTOR, INSURANCE SUPERVISION, PRA**

# FPS mandatory APP fraud reimbursement requirement





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# Background to research reforms

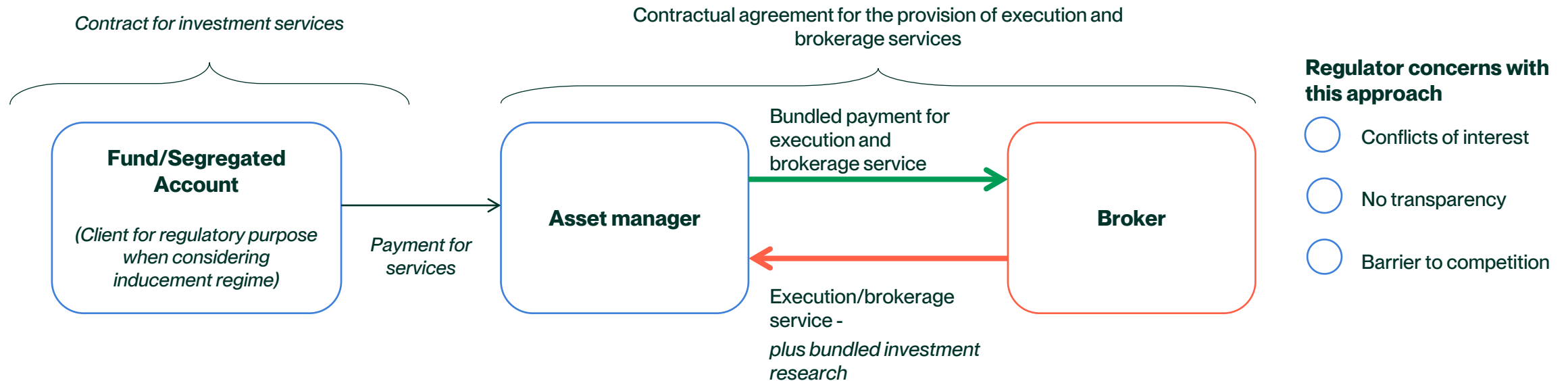
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**POSSIBLE FUTURE CHANGES TO THE UK  
INVESTMENT RESEARCH RULES**



# Historic approach to investment research

Before the FSA unbundling reforms 20 years ago it was common in the UK for investment research to be provided along with execution services using a “bundled” commission payment (soft commission arrangement)



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# Recap: Where we are post-MiFID II?

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## RULES

- ◆ UK MiFID firms are subject to inducements rules and must not pay to/provide or accept/receive from any non-client any fee, commission or **non-monetary benefit**
- ◆ However, there are carve-outs for certain types of research, meaning they fall outside scope of this restriction
- ◆ Plus there is a specific exception for research which is paid for in a certain way

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## RESEARCH CARVE-OUTS

- ◆ Pre-issuance research
- ◆ Trial basis research
- ◆ SME research
- ◆ FICC research
- ◆ Research providers not providing execution services
- ◆ Openly available research

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## PAYING FOR RESEARCH

- ◆ UK MiFID firms are allowed to receive investment research without it breaching the inducements rules provided it is paid for in a certain way
- ◆ For third-country research providers, this means that they may need to consider how they charge the UK MiFID firm recipient
- ◆ This can cause issues with bundled research and execution services

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# Impacts and challenges of MiFID II regime

There are two ways in which firms would be able to receive research in accordance with **COBS 2.3B** in the FCA handbook (meaning it could be received without breaching the inducements rules)

01

Direct payments by the firm out of its **own resources**

02

Payments from a separate **research payment account** controlled by the firm, provided that the firm meets the requirements in COBS 2.3B.4R relating to the operation of the account

## Significant impact in practice

Research could not be received in a “bundle” with other services

- ◆ *Domestic impacts* – RPAs operationally complex and resource intensive, many managers decided to pay from their own resources, this may create barriers to entry
- ◆ *Domestic impacts* – adverse impact on provision of research, decrease in quality and availability of research on UK listed firms, leading to adverse impact on economic growth
- ◆ *International impacts* - concern UK managers received less research from global providers, putting them at a disadvantage
  - ◆ This is especially true of the US, where certain types of brokers providing research would breach their US-law regulatory requirements if they received payments for research from UK firms out of the UK firm’s own resources or a separate payment account.

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# Proposed changes

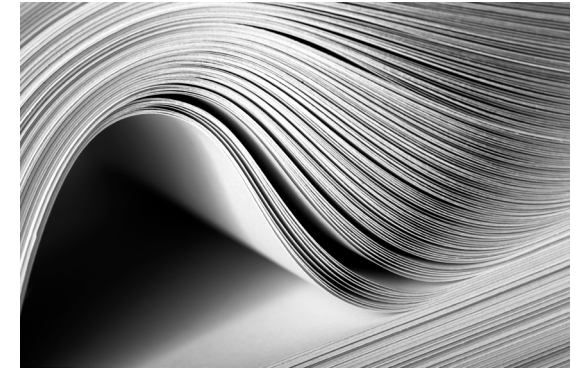
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**FUTURE CHANGES TO THE UK INVESTMENT  
RESEARCH RULES**



# Different but the same?

While the EU and UK MiFID rules are diverging, there are areas of overlap in the changes already made, and the changes being proposed, each side of the Channel.



## EU

### EU “quick fix” changes *(in force)*

Research may be bundled with execution services **where it relates to issuers whose market cap is < €1bn** provided certain other criteria also met

01

02

**EU MiFID/MiFIR Review**  
No research-specific changes

03

### EU Listing Act proposals

Two key amendments to MiFID II:

- ♦ **Greater ability for firms to bundle research and execution** by increasing €1bn cap to €10bn;
- ♦ New rules for issuer-sponsored research including **code of conduct for issuer-sponsored research**

## UK

04

### UK “quick fix” changes *(in force)*

Research may be bundled with execution services in certain circumstances **including where it relates to issuers whose market cap is < £200m**

05

**UK Wholesale Markets Review**  
No research-specific changes

06

### UK Investment Research Review

Development of seven recommendations, two of which are:

- ♦ **Greater ability for firms to bundle research and execution** by giving greater optionality for investment research payment
- ♦ New framework for code of conduct for issuer-sponsored research


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# UK Investment Research Review

The UK Investment Research Review was announced as part of the Edinburgh Reforms in December 2022, and the report was published in July 2023. The report contained seven recommendations intended to be progressed in 2024. The FCA is prioritising **recommendation 2** which relates to optionality for paying for investment research (i.e. permitting bundled research).

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## RECOMMENDATIONS (IN SUMMARY)

- 01 Introduce a Research Platform to help generate research
  - 02 **Allow additional optionality for paying for investment research**
  - 03 Allow greater access to investment research for retail investors
  - 04 Involve academic institutions in supporting investment research initiatives
  - 05 Support issuer-sponsored research by implementing a code of conduct
  - 06 Clarify the UK regulatory regime in relation to research
  - 07 Review the investment research rules in the context of IPOs
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### Expected developments in 2024

- ◆ **Continuing industry engagement** (buy-side and sell-side) both on recommendation 2 (optionality for paying for investment research) and other recommendations (including recommendation 6 (clarifying the UK regulatory regime in relation to research))
- ◆ **FCA consultation on recommendation 2** (optionality for paying for investment research) closed on 5 June
- ◆ **FCA rules on recommendation 2** (optionality for paying for investment research) expected imminently now that election has concluded

*At Mansion House 2023, all recommendations addressed to the Government were accepted by the Chancellor, and the FCA committed to consider the report and recommendations in relation to optionality for paying for research on an accelerated timetable.*

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# Payment optionality – overview

FCA consulted on new rules to support payment optionality in April this year. The consultation closed at the start of June and new rules are expected imminently

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## KEY PROPOSALS

- ◆ Greater flexibility
- ◆ Firms will now be able to pay for research through:
  - Own funds
  - Research payment account
  - Bundled research and execution payments
- ◆ Inclusion of short-term trading commentary as a new acceptable minor non-monetary benefit

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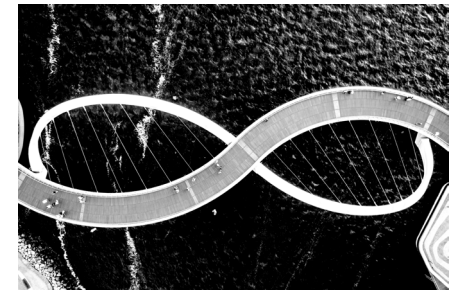
## IMPACT

- ◆ FCA will measure success by take-up of the new option

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## ADDITIONAL CONSIDERATIONS

- ◆ Not a full reversion to pre-MiFID II
- ◆ FCA also proposing to require a number of guardrails to support protection of client interests and management of conflicts of interest





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# Payment optionality – guardrails

The re-introduction of permitting bundled payments for research is accompanied by checks and balances designed to continue to mitigate against perceived harms of pre-MiFID II regime. These include the need to be able to clearly identify research charges and the creation of new guardrails that firms must comply with when operating under the bundled payments model.

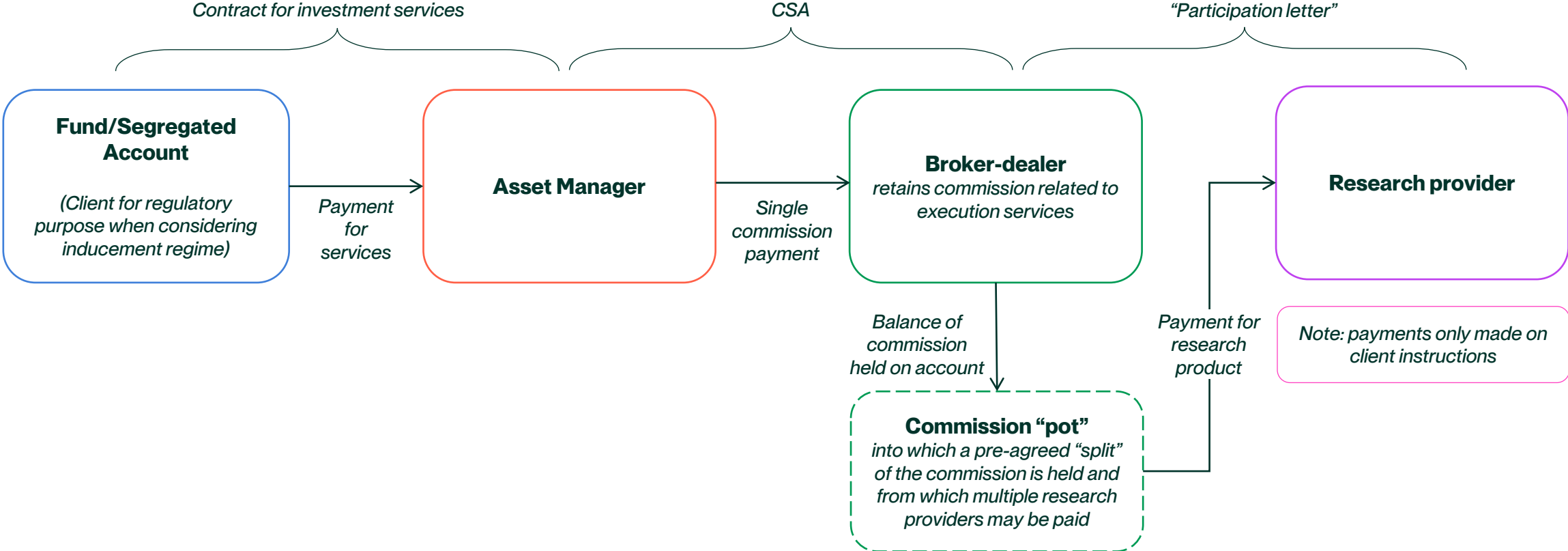
## RE-BUNDLING – KEY GUARDRAILS

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- 01** Formal policy on joint payments
- 02** Written agreement setting out methodology for research cost calculation and identification
- 03** A structure for the allocation of payments between research providers to allow for access to a range of research
- 04** A fair process for the allocation of costs between clients
- 05** Establishing a budget for the purchase of research using joint payments
- 06** Disclosure to clients covering: approach to joint payments; expected annual costs (ex ante and post); performance against budgets; top providers and total payments on research
- 07** Assessment of the quality, use and value of research, including benchmarking of providers
- 08** Operational procedures for the administration of accounts used for purchasing research

# CSA Arrangement – Back to the Future

In the UK, after the FSA unbundling reforms Commission Sharing Arrangements (CSAs) became common market practice pre-MiFID 2, with the blessing of the FSA



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# US impacts



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# US Regulatory Considerations

**Under US securities laws, the receipt of direct payments for research, as required under MiFID II, threatens classifying broker-dealers as investment advisers, thereby subjecting them to more extensive regulatory obligations.**

## The Status Quo

The U.S. Investment Advisers Act 1940 (“Advisers Act”) states that someone who provides advice, including securities research, for investing in or valuing securities in return for compensation is an investment adviser.

Under the Advisers Act, investment advisers may be subject to registration requirements, extensive compliance obligations, fiduciary duties, and restrictions on principal trading.

Broker-dealers are exempted from this classification, and therefore the regulatory obligations under the Advisers Act, if their advice is “incidental” to their brokerage services and they received “no special compensation” for their advice.

In practice, broker-dealers relied on this exemption by receiving research compensation through commissions, or “soft-dollar” payments, which are not considered special compensation.

## Impact of MiFID II

Any payments made out of a client’s own resources, or from its manager’s own resources, under MiFID II will constitute “hard-dollar” payments. These are considered special compensation under the Advisers Act.

Broker-dealers that receive hard-dollar payments may therefore no longer be able to rely on the incidental exemption, meaning they will be classified as investment advisers and be subject to the regulatory obligations they have previously avoided.

# US Regulatory Considerations

## SEC No-Action Relief

A no-action letter is a form of regulatory relief provided by the SEC pursuant to which the SEC will not recommend enforcement action against the requester based on the facts and representations described in the underlying request letter, and, in certain instances, against other parties with substantially similar facts and circumstances.

In response to MiFID II, from October 26, 2017 through July 3, 2023, the SEC issued a series of no-action letters granting broker-dealers temporary relief from the requirements of the Advisers Act.

October 26, 2017	November 4, 2019	July 3, 2023
<ul style="list-style-type: none"><li>• The SEC issued a no-action letter permitting broker-dealers to receive payments in hard dollars from a client subject to MiFID II without being considered an investment adviser.</li><li>• This letter was set to expire on July 3, 2020.</li></ul>	<ul style="list-style-type: none"><li>• The SEC extended the issued no-action letter.</li><li>• The SEC clarified that the incidental exemption may also be applied to Client Commission Arrangements.</li></ul>	<ul style="list-style-type: none"><li>• No-action relief granted by the preceding letters expired.</li><li>• In July 2022, the SEC stated that the SEC Hard Dollar No Action Letter would not be extended beyond July 3, 2023, forcing firms to consider additional solutions.</li></ul>

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# US Regulatory Considerations

## Current Solutions

To address the implications of MiFID II, broker-dealers have done the following:

- Opted to be subject to the Advisers Act's requirements
- Moved their research operations to an affiliate investment adviser, who incurs the regulatory obligations of an investment adviser so the broker-dealer does not have to
- Limit their research operations

## Effect of the Reforms

-  Additional optionality in paying for investment research (i.e., through a bundled payment) may allow US broker-dealers that do not receive hard-dollar payments to once again utilize the incidental exemption under the Advisers Act and, as a result, reengage in providing research services according to their pre-MiFID II framework.
-  Firms that chose to comply with the Advisers Act, or moved research operations to a registered investment adviser, may be unlikely to reverse such changes given the operational challenges associated with deregistration as an investment adviser and/or reintegrating research and broker-dealer operations into a single entity.
-  Firms paying for research (for the benefit of its clients) pursuant to MiFID II's requirements may reassess whether they will continue doing so, or pass research costs back onto clients.

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