MiFID II

Soft commission and payment for investment research

Dechert LLP

MiFID II planning and implementation is a top priority for asset managers affected by European regulations and brings with it both challenges and opportunities.

The Council of the European Union on 13 May 2014 formally endorsed a new regulatory regime that will replace the current Markets in Financial Instruments Directive (MiFID), which has been in force since 2007. The new legislation, in the form of a recast Directive (MiFID II) and Regulation (MiFIR), is scheduled to go into effect on 3 January 2018.

What's new under MiFID II for soft commissions?

Under current practice investment firms commonly use commission sharing agreements (CSAs) under which a broker retains a portion of the commissions attributable to execution and holds the balance to the investment firm's order, which is then used to pay for external research (the "soft dollar" model).

MiFID II introduces a new model under which research provided by a third party to an investment firm must be paid for out of either:

- The firm's own resources (the "hard dollar" model); or
- A research payment account (RPA) funded by a specific charge to the client and controlled by the investment firm.

Legally, the key difference is that the research charge will be an additional charge levied by the investment firm on its client (in addition to the management fee). By contrast, soft dollar commissions are levied by the broker.

Operationally, the key difference is that payments for research are collected into an RPA maintained by the investment firm, rather than into a CSA account maintained by the broker. This difference may be mitigated however by the fact that the investment firm can delegate administration of the RPA to a third party.

The changes to the rules aim to achieve transparency and reduce conflicts of interest. The FCA's longstanding objection to soft dollar arrangements is that they amount to a "hidden cost" for investors.

Who will the new rules on research payments apply to?

The MiFID II rules on commissions will apply to MiFID authorised investment firms providing portfolio management services to clients. The FCA has announced that it intends to extend the rules to AIFMs and UCITS mancos in their role as collective portfolio managers.

Investment firms that have not been appointed by the client to provide these services are not within the scope. However, the FCA has indicated that it will extend the

2007	**2011**	**2014-2015**	**2016**	**3 July 2017**	**3 January 2018**
MiFID in force	Proposal for MiFID II	ESMA consults on implementation	MiFID II application delay confirmed	Deadline for incorporation of MiFID II into EU Member State national law	**MiFID II and MiFIR apply**

rules to UCITS and AIFMD management companies acting as managers for UCITS or AIFs.

What are the rules relating to a Research Payment Account?

If an investment firm opts to use an RPA, the operation of the RPA must meet the following conditions:

– The RPA is funded by a specific research charge to the client based on a research budget set by the investment firm and agreed by the client;

– The investment firm is held responsible for the research payment account; and

– The investment firm must regularly assess the quality of research based on robust quality criteria and prepare and provide a written policy to clients which addresses the extent to which research purchased through the RPA may benefit clients' portfolios.

There are also disclosure requirements for an investment firm using an RPA:

– Investment firms must provide each client with information about the budgeted amount for research and the amount of the estimated research charge prior to the provision of investment services.

– Investment firms must provide annual information on the total costs that each client has incurred for third party research.

– Clients and/or competent authorities may request an investment firm to provide a summary of the providers paid from an RPA, the total amount they were paid, the benefits and services received by the investment firm, and how the total amount spent from the account compares to the budget set by the firm for that period.

Investment firms will therefore need to keep a clear audit trail of payments made to research providers and how the amounts paid were determined with reference to the quality of the research provided.

Next steps for investment firms

The new rules represent a potentially significant restriction on the ability of a portfolio manager to use softed services and such managers will need to examine their practices carefully to identify where adjustments to current practices will need to be made.

If an RPA is to be used, a portfolio manager should:

– Perform a gap analysis of its current research budgeting process compared to MiFID II requirements and develop plans to address any gaps identified;

– Develop and implement a process for setting research budgets on a client-by-client basis and obtaining individual client agreement in relation to budgets, which could include revisions to existing and template Investment Management Agreements and general Terms of Business; and

– Define and develop an approach and methodology to address the client or competent authority reporting and disclosure requirements.

International managers running global soft dollar accounts will have to determine how to reconcile practice in the rest of the world with the new EU restrictions. They should consider whether it is possible and desirable to separate EEA clients from other clients to avoid cross-subsidisation to ensure non-EEA clients are not paying for research to be used by EEA clients.

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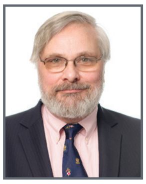

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