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Additional Information

Level 1 Regulation

Markets in Financial Instruments Directive II (MiFID II) Directive 2014/65/EU- Investor Protection and Intermediaries

Topic

Inducements (research)

Subject Matter

Inducements

Question

What approach should firms adopt to ensure that the allocation of their research budget to third party providers and the determination of the payments made from it are in the best interests of the firm's clients under Article 13(6)?

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Original language

[ESMA 35-43-349 MiFID II Q&As on Investor protection Ch. 7, question 10]

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. Where an investment firm wishes to purchase research centrally within the firm and make it widely accessible to internal staff, it is particularly important that firms have systems and policies in place to allocate costs fairly to clients and explain their approach in the written policy (Article 13(8) of the DD) (See also Q&A1). This 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.

Budgeting for research should take place at the outset of the research procurement process in order to determine the level of the research charge in the best interest of clients. Budgets need to be regularly reviewed. The research budget is thus 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.

Once the budget is set for a specified period, Article 13(6) of the Delegated Directive requires that "the allocation of the research budget to purchase third party research should be subject to appropriate controls and senior management oversight to ensure that it [the research budget] is managed and used in the best interest of the firm's clients." It notes that this should include having "a clear audit trail of the payments made to research providers" and controls over how amounts paid to providers are determined with reference to the quality criteria established by the firm (Article 13(6) of the Delegated Directive).

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. This means that firms should carefully consider whether their policies and research procurement systems are designed to minimise any conflict of interest that may arise. Portfolio managers should be particularly aware of such risks when purchasing research alongside execution services. Doing so in a way that is compliant with MiFID requires severing the link between transaction volumes and value and the amount paid for research inputs (Article 13(2)(b) of the Delegated Directive).

For this reason, it is expected that an investment firm should ensure research inputs are assessed in accordance with internal policies and procedures, and are allocated a value to help the firm determine the level of payments to be made to providers. Similarly, investment firms supplying research should be able to explain how they price their services, especially where they also provide execution services, to enable them to evidence that their research pricing is not influenced or conditioned by other payments for execution services (Article 13(9) of the Delegated Directive). ESMA considers that so called 'waterfront' subscription arrangements where firms agree to pay a periodic subscription fee to receive access to research could be compatible with MiFID II rules, provided that the fee can be justified by expected benefit to the client.

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 measureable ex ante criteria as to how it will value the types, level and quality of service. This can provide the basis for agreements with each service provider on the level of payment expected for the anticipated provision of services. At the end of the period, based on actual services received, the firm may adjust the payment made to the research firm in a proportionate and predictable manner based on those criteria. The total amount of payments should still be aligned with the budgeted amount of research and be justifiable in terms of the benefit for the client.

A firm may, for example, have its own internal 'rate cards' or thresholds to adjust what it will pay individual providers for specified service levels. This should allow firms to negotiate with suppliers to set ex ante expectations of payment levels, and enable the firm to demonstrate they have applied appropriate controls in determining actual payments to providers for services received. By clearly linking payments to inputs and services, it should mitigate the

conflicts of interest risk that research payments to providers could be perceived to be rewarding other non-research benefits and ensure payments are in the best interests of the client.

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 scope for firms to negotiate research prices with suppliers, based on their own approach to ascribing value to specific service levels. 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. In line with Article 13(2)(b), 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.