ALERTS

MiFID II: Final FCA Rules Published

10 July 2017

On 3 July 2017, the Financial Conduct Authority ('FCA') published its second policy statement ('Policy Statement') on the UK implementation of the revised Markets in Financial Instruments Directive ('MiFID II'). The Policy Statement sets out the final rules and guidance on conduct of business, client assets and certain other matters. The first FCA policy statement[1] was published in March 2017 and covered areas such as trading venues, rules applicable to algorithmic and high-frequency trading, and certain firm organisational requirements.

The Policy Statement covers some of the key rules and guidance of interest to asset managers, including the administration of research payment accounts, best execution requirements, telephone taping and client categorisation.

Inducements and Research

Application of the Unbundling Rules

Under MiFID II, research is treated as a type of banned 'inducement' except where: (i) the manager pays for such research out of its own resources; or (ii) the research is paid for through a Research Payment Account ('RPA') controlled by the manager and funded through a specific research charge to the client based on a pre-agreed budget. To facilitate the unbundling, EU brokers will be required to identify the charges for executing transactions separately from research and any other services or benefits they provide. Moreover, the supply and charges for such other services or benefits may not be influenced or conditioned by the levels of commission payments.

The Policy Statement confirms that MiFID II rules on unbundling of research will be extended to UK alternative investment fund managers ('AIFMs') and UCITS management companies, as originally proposed by the FCA. The only exception has been provided for private equity fund managers whose core investment policy involves investing either in the types of financial instruments not capable of being held in custody, or in interests in unlisted companies with a view to acquiring control of such companies.

Budgeting for Research and Operation of RPAs

MiFID II requires managers to set and regularly assess a research budget which forms the basis for the research charges levied on their clients. Managers are required to adopt detailed procedures for valuing research based on robust criteria to ensure that the research they buy benefits their clients. Research budgets may be set at client level or at strategy level, where several client portfolios have similar research needs. The costs of third-party research must be allocated fairly among the various clients whose portfolios benefit from it.

The Policy Statement clarifies that managers are not required to allocate a specific research payment to a particular provider in advance as part of budgeting. Instead, prior to receiving research services, managers must formulate a clear methodology for establishing what they expect to pay for research. Depending on the pricing model offered by the research provider, this guidance will allow managers some flexibility to adjust the payments based on their actual consumption of research services, such as access to analyst time. To this end, the FCA has noted that it will expect any agreements with research providers to allow for service and payment level reviews on a regular basis (at least once a year) to ensure that the research services received by the manager remain in the best interests of its clients.

During the consultation on the draft rules[2], the FCA expressed a preference for a single RPA per research budget to be maintained. This meant that the only feasible solution would have involved a third-party RPA administrator to facilitate the collection of the research charges and payments out of the RPA to research providers. The Policy Statement allows the possibility of maintaining multiple RPAs (e.g., administered by different brokers). The FCA has accepted that a 'virtual RPA' that gives the manager a consolidated view of multiple underlying RPAs is permissible under the rules, so long as each underlying RPA is adequately

protected, including ring-fencing of the funds in the RPA to be used exclusively to pay the research charges.

Managers will also be permitted to use a combination of RPAs and funding of third-party research out of their own resources. This option may be attractive to some managers with multiple trading strategies and clients where budgeting and allocation of research costs may not always be practicable.

The FCA guidance clarifies that the transfer of charges into an RPA should be effected without undue delay and, in any case, within 30 calendar days from a transaction taking place. The FCA considers that netting of payments, where research charges are being passed from a broker's commission-sharing account into an RPA, would not be consistent with the requirements of MiFID II and would have the potential to reduce both the transparency and oversight of the RPA by the manager.

In an unwelcome move, the Policy Statement clarifies that the costs of administering the RPA may not be passed on to clients and must be paid for by the manager out of its own resources. The rationale for this policy decision is that RPA administration costs cannot be categorised as either research costs or execution costs. The same principle applies to the provision of third-party trade analytical tools and order management systems.

Consistent with its approach under the current Use of Dealing Commission rules[3], the FCA has re-emphasised its view that market data does not constitute research and must not be funded through an RPA.

Minor Non-Monetary Benefits

The FCA has confirmed that trial periods for research are permissible minor non-monetary benefits, provided that the trial period is limited to no more than three months. Managers should not accept a new trial with the same provider within a 12-month period from the expiration of the previous trial period or research agreement.

Research provided by analysts of a syndicate bank acting on behalf of a corporate issuer in the context of a primary market capital-raising event (or 'connected research') can be treated as an acceptable minor non-monetary benefit. The FCA views this type of research as comparable to

issuer-commissioned research coverage permitted under Article 12(3)(b) of the MiFID II Delegated Directive.

The FCA has noted that managers could accept transaction reporting services as part of the execution service, provided that the transaction reporting services are offered by the broker as a standard term of business. This may cover the assisted MiFID II reporting services, as well as EMIR-delegated reporting, provided that these services are in fact offered by the broker as standard, rather than to a select group of clients.

Disclosure of Research Charges

The FCA has clarified that AIFMs will only be required to provide annual disclosures of research charges to investors on request. These periodic disclosure requirements consist of: (i) a summary of the providers paid from an RPA; (ii) the amount each of them was paid; (iii) the benefits and services received by the firm; and (iv) how the total amount spent compares to the research budget set by the manager, noting any rebates or amounts carried over to the next period.

The Policy Statement confirms that, in a fund context, managers will be required to agree the research charge and the frequency with which this charge will be deducted with the board of the fund (or its general partner), rather than obtaining investor consent to the research budget. However, the research budget and estimated research charge will need to be disclosed to existing and potential investors.

Groups and Non-EU Firms

The FCA has clarified that UK brokers are not required to price research and execution separately when providing research and execution services to non-EU firms. This will mean that UK brokers will be able to continue with the existing soft dollar arrangements with non-EU managers.

The Policy Statement acknowledges the issues presented by the interaction between MiFID II and US regulatory framework, and in particular, the ability of US broker dealers to accept separate payments for research. The FCA reiterated ESMA Q&A which provide that no exemption from the MiFID II inducements rules is available where EU managers obtain their research from providers in non-EU jurisdictions. The FCA will continue to monitor this issue and may provide an update in due course.

The Policy Statement is silent on the approaches that may be adopted in the context of global manager groups where research consumed by a UK manager is sourced through its non-EU affiliate. Equally, the FCA has not addressed the question of how MiFID II research rules are meant to apply in the context of a UK manager delegating some of its management functions to a non-EU affiliate.

Best Execution

In a surprise move, the FCA has decided not to apply MiFID II best execution requirements to UK AIFMs. As a result, UK full-scope AIFMs will not be required to publish the data relating to top five execution venues or brokers on an annual basis and will remain subject to the existing best execution standard under the Alternative Investment Fund Managers Directive ('AIFMD')[4]. This will apply equally to full-scope AIFMs that have 'top up' MiFID permissions. The FCA intends to monitor the outcome of the upcoming AIFMD review by the EU Commission[5], which may propose enhancements to the best execution standards for AIFMs.

MiFID II best execution rules will be extended to UCITS management companies, with minor modifications to tailor these requirements for the provision of collective portfolio management services. Small UK AIFMs authorised as MiFID firms will also be subject to the MiFID II best execution rules.

Telephone Taping

The Policy Statement confirms that the existing exemption from telephone taping requirements will be removed. As a result, all UK managers will become subject to MiFID II telephone taping requirements, which require recording of telephone conversations and electronic communications relating to all actual or intended transactions.

The FCA has clarified that the focus of this regime is on the transactional side of portfolio management. The taping requirements will only cover calls either directly related to the conclusion of a transaction or intended to result in a transaction. As such, other types of communications, including investor relations calls, are unlikely to be captured by the telephone taping rules.

Client Categorisation

EU firms that provide investment services are required to categorise their clients as eligible counterparties, professional clients or retail clients. This categorisation determines the degree of investor protections afforded to the client. The categorisation as a professional client is also relevant in the context of marketing an alternative investment fund, which may generally only be offered to professional investors.

Under MiFID II, municipalities and local authorities are not considered to be 'professional clients', except if they elect to be treated as such and meet the test for an 'elective professional client'. This test includes both qualitative (i.e. assessment of experience and understanding of risks) and quantitative tests described below.

EU Member States have discretion to introduce stricter quantitative criteria for assessment of local authorities as professional clients and the FCA had initially proposed to modify the MiFID II quantitative test to require local authorities to have investment portfolios that exceed GBP 15 million[6].

The Policy Statement lowers this threshold to GBP 10 million. In addition, the manager will need to be satisfied that the local authority meets at least *one* of the following quantitative criteria: (i) the local authority client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters[7]; (ii) the individual authorised to carry out transactions on behalf of the local authority client works or has worked in the financial sector for at least one year in a professional position which requires knowledge of the provision of the service envisaged; or (iii) the client is an 'administering authority' of a Local Government Pension Scheme within the meaning of the Local Government Pension Scheme Regulations.

In respect of the qualitative test, the FCA has specified that a manager may take into account the collective experience and knowledge of the officials acting as part of a local authority's pensions committee.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] FCA Policy Statement PS17/5.

[2] FCA CP 16/29.

[3] COBS 11.6.

[4] The AIFMD best execution standard requires AIFMs to take all reasonable steps to obtain the best possible result for the AIFs they manage or the investors in these AIFs, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. See Art. 27 of Commission Delegated Regulation (EU) 231/2013.

[5] The EU Commission has taken the first step in the review of AIFMD by inviting tenders for a market study of the alternative investment industry.

[6] Compared to EUR 500,000 in MiFID II.

[7] This test is generally undertaken by comparing the prior investment history of the client to the types of transactions that may be undertaken as part of the prospective portfolio management service.

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