

## Public consultation by the AMF on the new rules for the funding of research by investment firms under MiFID II

### Overview of the consultation

- *Background and regulatory framework of this consultation*

Given the forthcoming transposition of the revised markets in financial instruments directive (MiFID II)<sup>1</sup> and the delegated directive<sup>2</sup> published on 7 April, the AMF wishes to consult operators and associations in the Paris marketplace about the principles for the operational implementation of the new rules governing the funding of research.

The provision to investment firms (IFs), and particularly firms that provide portfolio management services, of research documents published by financial intermediaries or research firms, will now fall within the regulated category of inducements.

As such, the funding of research is now governed by MiFID II, in order to protect investors and limit the risks of conflicts of interests.

Article 13 of the Delegated Directive of 7 April 2016 therefore describes how “inducement” rules should be applied to the particular case of the provision of third party research to investment firms.

More specifically, Article 13 now requires the funding of research through one of the following two methods:

- Direct payment for research using the IF’s own resources; or
- Payment charged to the IF’s clients but from a separate research account, as agreed with the client and monitored by the IF, under certain operational and transparency conditions.

This provision is a major innovation as, under MiFID I, the provision of research was never treated as a form of inducement.

In accordance with Article 93 of MiFID II, it will enter into force on 3 January 2018<sup>3</sup> after its transposition into national law, which must be completed before 3 July 2017.

Article 13 of the Delegated Directive will therefore be enacted in French law. This enactment is expected to take place through the AMF’s General Regulations, a draft version of which will be presented to the marketplace at a later date and be subject to a separate consultation.

Even though it is a directive rather than a regulation – which could offer the French authorities a degree of leeway in the enactment of the provisions in French law – a literal transposition of Article 13 is preferred at this stage. This Article’s wording is in fact highly detailed and precise. The provision is, moreover, the result of a compromise reached following highly involved discussions and negotiations that might be undermined by a non-literal transposition.

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<sup>1</sup> European Parliament and Council Directive 2014/65/EU of 15 May 2014 on markets in financial instruments, amending Directive 2002/92/EC and Directive 2011/61/EU and available at the following address <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN>

<sup>2</sup> The Commission Delegated Directive of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and Council with regard to the safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or receipt of fees, commissions or any monetary or non-monetary benefits.

<sup>3</sup> The entry into force of MiFID II and the MiFID regulations has been postponed by one year to 3 January 2018, through the publication of an amended text in the OJEU on 1 July.

The consultation launched here is not, strictly speaking, a transposition exercise. It will not be a substitute for the necessary legislative and regulatory work and does not intend to pre-empt this work, and particularly the drafting of the AMF's General Regulations, which will give rise to a specific consultation at a later date.

It has two main objectives:

- To give guidance to IFs – and particularly those that offer discretionary portfolio management services – to help them to understand this new regulation so that they can draw the due consequences in their daily activities;
- To suggest practical responses to the main issues raised by the introduction by IFs of the new research funding rules, especially regarding the scope of the new rules' application (e.g. what is a research document?) and the operational rules for the research account mechanism, which is the text's biggest innovation.

It is of course not designed to provide a comprehensive list of issues, which will only be identified in practice, or a substitute for any clarifications that may be made in the future by the European Securities and Markets Authority (ESMA).

A revised version of this document may be published in the form of a position paper or recommendation depending on the feedback from this consultation.

- *The general aim of the reform is to govern conflict of interest risks more strictly*

One of the main objectives of MiFID II is to strengthen the provisions aimed at preventing and managing any kind of conflict of interests. Accordingly, this directive introduces a number of measures that govern relations between IFs and their service providers, which are defined by the Delegated Directive. MiFID II stipulates, for example, that an entity cannot pay or receive remuneration or a fee, or provide or receive an inducement, unless the purpose of the payment or inducement is to improve the quality of the service provided to the client and is not detrimental to compliance with the IF's obligation to act honestly, fairly and professionally, in the best interests of its clients. It is also strictly prohibited to receive any inducements by retaining them in connection with the provision of a portfolio management or independent advice service.<sup>4</sup>

The treatment, under the inducement rules, of the provision of research services to portfolio managers was debated at length during the preparation of the technical advice published by the ESMA in December 2015 (so-called "level 2" work). The Delegated Directive sets out the conditions in which the provision of research services should not be viewed as an inducement, meaning that their cost may be borne by client portfolios.<sup>5</sup>

Access to high quality, diverse research is an "active" portfolio managers' essential tool, as it is part of their investment decision process. The provisions set out by MiFID II will profoundly change the funding of research and call many existing models into question.

Whereas previously this research was usually funded by the portfolios under management through intermediation fees (with the possibility of allocating part of this funding to a research provider other than the provider of the execution service, where appropriate), this funding arrangement is now strictly governed by a budgetary process designed to ensure that the research services purchased by the manager are useful to their decision-making process and that the amounts paid are not correlated with the portfolios' turnover. The Delegated Directive therefore stipulates that the research expenses borne by

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<sup>4</sup> Inducements considered to be minor are acceptable (in accordance with Article 12, paragraph 3 of the Delegated Directive).

<sup>5</sup> Article 13 of the Delegated Directive of 7 April 2016 is available at the following address:  
[http://ec.europa.eu/finance/securities/docs/isd/mifid/160407-delegated-directive\\_en.pdf](http://ec.europa.eu/finance/securities/docs/isd/mifid/160407-delegated-directive_en.pdf)

portfolios under management will only be legitimate if they are strictly determined by reference to a budget, which must be:

- “Based on a reasonable assessment of the need for third party research” and on the capacity of the research to contribute to better investment decisions;
- Accompanied by a regular process of assessment of the quality of the research bought;
- Allocated fairly to the different types of portfolio;
- Contractually agreed with clients.

Note that the manager will still retain the possibility of funding research using its own resources.

This exercise, which is complex but has been made mandatory by the directive, is new for portfolio managers. The purpose of this document is therefore to assist them with this new process described by the Delegated Directive. It is not intended to go beyond the directive’s requirements, but to present its key points to operators for ease of implementation by reminding the concerned operators of their responsibilities. Flexibility is also important, particularly in the prior setting of a budget. Although the manager is expected, when preparing its budget, to produce reasonable estimates of the research required, this budget setting process should not prevent them from reallocating certain expenses initially budgeted for the current period, if necessary, as their research needs change. Such changes, if they are duly justified, appear to be legitimate.

- *Who is affected by this reform?*

These new provisions only apply to the provision of research to investment firms subject to MiFID II and do not therefore apply to the provision of research to management companies in connection with their collective management activities.

That being said, given the application of certain MiFID II rules to management companies that offer investment services, these provisions apply to the provision of research to management companies that offer investment services, and particularly portfolio management (discretionary management) and investment advice services.<sup>6</sup>

For the sake of convenience, any reference to “IFs” should therefore be understood, in this document, to refer to investment firms, credit institutions and management companies that offer an investment service as defined by Section A of Annex 1 to MiFID II.

### The key points of the consultation

At this stage, this consultation is restricted to the funding of research used to carry out trades on the equity market. The application of the funding rules imposed by the Directive to research connected with fixed income trades will undergo additional analysis.

This three part consultation examines:

- The definition of the services that may be funded by portfolios under management and therefore included in the research budget. The aim is to suggest principles defining research to allow every manager to assess whether the document or service provided to them can be charged to the portfolio under management. Certain situations that IFs may face will also be more closely examined. It is important to note, however, that this assessment is the sole responsibility of the manager;

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<sup>6</sup> In accordance with Article 6 of the Directive of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Article 6 of the Directive of 8 June 2011 on alternative investment fund managers.

- The establishing of a research budget: this section presents a new mechanism for IFs. It presents the general criteria to be used to define a budget and to monitor changes in the latter and the mandatory information requirements due to clients ;
- The interfacing between the current system of shared brokerage commission agreements and the new texts. This involves determining the conditions under which they may continue to apply.

### Who is this consultation aimed at?

This consultation is aimed particularly at:

- Individual investors and their representatives;
- Investment firms, and especially portfolio management companies;
- Professional associations;
- Institutional investors;
- Non-investment firm service providers that provide portfolio management or financial analysis services;
- Consumer associations; and
- Consultancy and legal firms, and particularly firms that work within the financial industry.

### Texts referred to

- Directive 2014/65/EU of the European Parliament and Council of 15 May 2014 on markets in financial instruments, amending Directive 2002/92/EC and Directive 2011/61/EU ("MiFID II")
- The Commission Delegated Directive of 7 April 2016 supplementing Directive 2014/65/EU ("Delegated Directive")

### Procedure and deadline for responses

This consultation will end on **28 October 2016**. Participants are asked to send their responses and comments to the following address: [directiondelacommunication@amf-france.org](mailto:directiondelacommunication@amf-france.org)

Responses, comments and proposals put forward in connection with this consultation will help the AMF to transpose the provisions contained in the Directive in a practical manner.

**As such, the AMF invites views and opinions from all interested parties on its analysis of the new directive and its applicability to the fixed income market.**

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## 1. Proposed definition of services covered by the term “research”

Investment firms are responsible for ensuring that services funded from the research budget meet the description of “research” as set out below. Investment firms must therefore be able to justify that this is the case.

The aim of this section is to help portfolio managers identify those services that can be charged to client portfolios in the light of the definition given in the Directive<sup>7</sup>. Some services (macro research, corporate access, etc.) will be examined in the light of this definition to determine the extent to which they can be funded by a client, via the research budget, and, where applicable, under what conditions.

For the sake of clarity, this section points out that a number of expenses cannot, by their very nature, be included within the definition of research, since they do not meet the criteria laid down in the definition. The AMF published a list of such services in 2007 and will review whether this list should be updated.

Finally, it is emphasised that services that cannot be described as “research” as set out below can only be funded from an investment firm’s own funds, unless they are considered to represent minor non-monetary benefits that in no way influence its choice of action towards the service provider in question<sup>8</sup>.

### 1.1 Criteria defining research

Recital 28 of the Delegated Directive stipulates as follows:

“In order to ensure that portfolio managers and independent investment advisers properly monitor the amounts paid for research and to ensure that research costs are incurred in the best interests of the client, it is appropriate to specify detailed governance requirements on research spending. Investment firms should retain sufficient control over the overall spending for research, the collection of client research charges and the determination of payments. Research in this context should be understood as covering research material or services concerning one or several financial instruments or other assets, or the issuers or potential issuers of financial instruments, or be closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector. That type of material or services explicitly or implicitly recommends or suggests an investment strategy and provides a substantiated opinion as to the present or future value or price of such instruments or assets, or otherwise 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.”

### 1.2 Criteria defining services that can be assigned to the research budget

In order for any document or service to be eligible as research under Article 13 of the Delegated Directive, both of the following criteria, taken from recital 28<sup>9</sup> of the Directive, must be met:

<sup>7</sup> In recital 28.

<sup>8</sup> Paragraph 8 of Article 24 of the Level 1 Directive stipulates that “When providing portfolio management the investment firm shall not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm’s duty to act in the best interest of the client shall be clearly disclosed and are excluded from this paragraph.”

<sup>9</sup> Recital 28 stipulates as follows: “**Research in this context** should be understood as covering research material or services concerning one or several financial instruments or other assets, or the issuers or potential issuers of financial instruments, or be closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector.”

(i) The document or service must be research **material or services** concerning **one or several financial instruments or other assets, or current or potential issuers** of financial instruments, or research **material or services** closely related to a sector or specific market **such that it informs views** on financial instruments, assets or issuers within that sector or market.

(ii) This material or service **explicitly or implicitly recommends or suggests** an **investment strategy and provides an 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.

It is understood that the notion of "material" includes all forms of documentation, written or on durable media.

The Delegated Directive specifies that the definition of "research" applies in the specific context of Article 13. Consequently, this definition, which allows the definition of services that can be funded by a client, should not be applied to other European legal texts, such as for example the Market Abuse Regulation (MAR)<sup>10</sup>.

### 1.3 Items excluded de facto from the research budget

In accordance with the current provisions<sup>11</sup>, the costs of certain services cannot be taken into account in the research budget, in particular:

- goods or services corresponding to resources that the portfolio management company must have available in its programme of activity, such as administration or accounting, purchasing or premises rental, and staff compensation;
- services for which the portfolio management company receives a management fee

In 2007, the AMF published an instruction setting out a non-exhaustive list of such services: for example, portfolio valuation services and the purchase or rental of computers are goods or services corresponding to resources that the portfolio management company must have in its programme of activity. In the light of the new texts, the AMF is considering updating the list of prohibited services laid down in this instruction<sup>12</sup>.

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<sup>10</sup> The full text of the MAR is available at the following address:

[http://ec.europa.eu/finance/securities/abuse/index\\_en.htm](http://ec.europa.eu/finance/securities/abuse/index_en.htm)

<sup>11</sup> Article 314-83 of the AMF General Regulation.

<sup>12</sup> For example, while seminar registration could not be considered a service that helped with investment decisions or execution in 2007, it appears that this practice may now fall into one of the categories of minor non-monetary benefits.

#### AMF Instruction 2007-02

Investment decision and order execution support services  
Reference text: AMF General Regulation Article 314-79

Single article – Investment decision and order execution support services

Investment decision and order execution support services must meet the criteria set out in Articles 314-82 and 314-83 of the AMF General Regulation; they include, for example, all economic research and financial analysis services.

However, the following, in particular, are not considered to be investment decision and order execution support services:

- 1° portfolio valuation services
- 2° purchase or rental of computers
- 3° payment for communication services, such as electronic networks and dedicated telephone lines
- 4° seminar registration
- 5° subscription to publications
- 6° payment for travel and entertainment
- 7° payment for computer software, particularly order management systems and office administration software, such as word processing and accounting programs
- 8° membership of professional associations
- 9° purchase or rental of offices
- 10° payment of employee wages
- 11° provision of public information
- 12° direct cash payments
- 13° financial instrument custody and administration services

#### 1.4 Minor non-monetary benefits

Furthermore, any minor non-monetary benefit, which can be retained by the investment firm without any additional requirement is excluded from the MIFID II regime on inducements, since the associated risk of conflicts of interest is low. The Delegated Directive sets out an exhaustive list of those non-monetary benefits that can be considered minor. Clients must be informed of the existence of such benefits, even if only in generic terms.

Article 12 of the Delegated Directive stipulates as follows:

[...]

2. Investment firms providing investment advice on an independent basis or portfolio management shall not accept non-monetary benefits that do not qualify as acceptable minor non-monetary benefits in accordance with the sub-paragraph below.

3. The following benefits shall qualify as acceptable minor non-monetary benefits only if they are:

- (a) information or documentation relating to a financial instrument or an investment service, is generic in nature or personalised to reflect the circumstances of an individual client;
- (b) written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public;
- (c) participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service;
- (d) hospitality of a reasonable *de minimis* value, such as food and drink during a business meeting or a conference, seminar or other training events mentioned under point (c); and



(e) other minor non-monetary benefits which a Member States deems capable of enhancing the quality of service<sup>13</sup> provided to a client and, having regard to the total level of benefits provided by one entity or group of entities, are of a scale and nature that are unlikely to impair compliance with an investment firm's duty to act in the best interest of the client.

## 1.5 Application of the definition to certain specific documents or services

The Delegated Directive proposes a definition of the concept of research. However, certain situations may be open to debate. It is therefore proposed to focus in particular on specific cases to help investment firms in their analysis, for which a firm remains responsible and which it must be able to justify.

### A. General information

The purpose of this paragraph is to determine whether general information, such as journalistic content, can be considered fundable from the research budget.

The Directive answers this question to a certain degree, stating in paragraph 3 (a) of Article 12 that "generic" information relating to a financial instrument or an investment service is considered a form of "acceptable minor non-monetary benefit".

Insofar as the benefit in question constitutes a minor non-monetary benefit, it will not be charged to the investment firm by the service provider, and the investment firm will therefore not be able to charge the cost to its own clients.

### B. Macroeconomic analysis

Macroeconomic analysis does not usually cover any particular issuer or security, and more generally covers broad economic aggregates, global balances or one or more geographical regions, for example.

To be eligible for the proposed arrangements, this type of research must meet the research definition criteria set out in section 1.1. In particular, it must be original and serve to support investment decisions.

Nevertheless, questions may arise in connection with macroeconomic research distributed widely to a large client base for marketing or sales purposes. Insofar as such research has been widely disseminated, it might reasonably be considered that the provider has not allocated specific substantial resources to any given portfolio manager in order to produce it. Consequently, such research constitutes a minor non-monetary benefit which could be received by the investment firm free of charge, without compromising the firm's obligation to act in the clients' best interests.

### C. Commercial services

Regular business contact between investment firms and their market intermediaries, who highlight suggested investments ("trade ideas"), can also qualify as supporting investment decisions. Consequently, it is legitimate that they are subject to the same approach. As such, the definition criteria must be applied and verified by investment firms to check that the service provided does indeed fall within the definition of research. For example, if a member of a Sales department were to call a portfolio manager to pass on a brief - written by an in-house or external analyst - and position it in the context of current market developments, this might meet the criteria for being considered as part of a broader supply of research.

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<sup>13</sup> Article 12.3.e nevertheless leaves Member States a degree of latitude on the subject (see box).

## D. Corporate access

Corporate access can be defined as when a third party (e.g. a market intermediary) puts an investment firm in contact with an issuer of one or more financial instruments with a view to discussing that issuer's strategy, position or outlook.

Corporate access is a fairly widespread practice and generally provides managers with easier access to the executives of companies in which they have invested or are considering an investment. Up to now, this service has been part of the overall service provided by the intermediary, paid for by transaction fees linked to investment decision support services. Under the new definition of research, the provider and the portfolio manager need to further refine the definition of this concept and systematically review it in the light of the criteria defining research.

- **Straightforward introduction without provision of a service of an intellectual nature**

On the basis of these criteria, it may be difficult to see how merely providing a “concierge” service – i.e. where the provider introduces an investment firm to an issuer without providing any service of an intellectual nature – could meet the criteria for research laid down in the Delegated Directive. In which case, this would not naturally prohibit a straightforward service of introduction, but would not be able to be charged to the investment firm's client via the research budget.

However, as such:

- this could not be invoiced if it were to meet the definition of a minor non-monetary benefit ; this would generally be the case if the introduction did not require sufficiently substantial means to make the firm feel indebted to the provider, running the risk of not acting in the best interests of its client;
- conversely, this could be invoiced and therefore paid directly out of the investment firm's own funds.

- **Introduction accompanied by the provision of a service of an intellectual nature**

Conversely, if corporate access is combined with a higher added value service such as, for example, the preparation by an analyst of a detailed briefing note drawing lessons from a meeting attended by that analyst, recommending a given strategy in relation to the securities of the issuer in question or its industry sector and enabling the investment firm to form an opinion, enhanced corporate access service could be considered research within the meaning of Article 13 of the Delegated Directive. Consequently, the service provided could be funded by the IF's client from the research budget.

Similarly, when the analyst follows the security on a regular basis, the focus of the meeting between its issuer and the investor, and periodic research notes are sent to the investor on the given issuer's securities, the provided corporate access service, which is considered as complementary to the research notes - sent periodically to the investor- could also be charged to the client of the investment firm, via the research budget.

## 2. Operation of the research budget

The Delegated Directive provides that an investment firm may pay for research it receives either directly from own funds or by charging the cost to the portfolios it manages up to the amount of a predetermined research budget. It also lays down a number of criteria governing the determination and operation of this budget.

This second section therefore focuses on how portfolio managers are to (i) determine their overall budget and the budget for each of their clients, (ii) track expenditure against the budget, (iii) revise the budget where applicable and (iv) inform their clients about any expenditure to be charged to them in respect of the budget.

### 2.1 Arrangements for defining and monitoring the overall research budget

On this subject, Article 13 stipulates as follows:

“1.(b)(ii): as part of establishing a research payment account and agreeing the research charge with their clients, investment firms **set and regularly assess a research budget as an internal administrative measure**; [...]

(iv) the investment firm **regularly assesses the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions**”;

2. Where an investment firm operates a research payment account, Member States shall ensure that the investment firm shall also be required, upon request by their clients or by competent authorities, to provide a **summary of the providers paid from this account, the total amount they were paid over a defined period, 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**, noting any rebate or carry-over if residual funds remain in the account. For the purposes of point (b)(i) of paragraph 1, the specific research charge shall:

(a) **only be based on a research budget set by the investment firm for the purpose of establishing the need for third party research** in respect of investment services rendered to its clients; and

(b) **not be linked to the volume and/or value of transactions executed on behalf of the clients**. [...]

4. **The total amount of research charges received may not exceed the research budget.**

5. The investment firm **shall agree with clients**, in the firm's investment management agreement or general terms of business, **the research charge as budgeted by the firm** and the frequency with which the specific research charge will be deducted from the resources of the client over the year. Increases in the research budget shall only take place after the provision of clear information to clients about such intended increases. If there is a surplus in the research payment account at the end of a period, the firm should have a process to rebate those funds to the client or to offset it against the research budget and charge calculated for the following period.

6. For the purposes of point (b)(ii) of paragraph 1, the research budget shall be managed solely by the investment firm and **is based on a reasonable assessment of the need for third party research**. The allocation of the research budget to purchase third party research shall be subject to appropriate controls and senior management oversight to ensure it is managed and used in the best interests of the firm's clients. Those controls include a clear audit trail of payments made to research providers and how the amounts paid were determined with reference to the quality criteria referred to in paragraph 1(b)(iv). Investment firms shall not use the research budget and research payment account to fund internal research.”

## A. Establishing the research budget

In the light of the article reproduced above, the principles governing the establishment of the research budget may be defined as follows:

- **The budget estimates the cost of necessary research**

The *ex ante* determination of the research budget to fund the provision of high-quality research, for which the determining criteria are set out in a written policy, and the monitoring of the budget against the same type of criteria, ensure that research expenses charged to portfolios do not depend on the volume or value of transactions executed. Such expenses correspond to expenditure that supports decision-making in the best interests of the clients holding those portfolios. For many operators, this type of budget procedure represents a genuine change of model.

The research budget is thus an *ex ante* estimate of forecast expenditure for research costs that can be charged to portfolios under management. In accordance with paragraph 6 of Article 13 of the Delegated Directive, the budget must be “based on a reasonable assessment of the need for third party research”.

- **The overall budget must be sufficiently granular to be able to be pre-apportioned by portfolio**

In accordance with Article 13.1(c)(i) of the Delegated Directive, investment firms must, before providing the service, provide their clients with information on the intended research budget and the estimated amount of research charges for each of them.

When setting its overall budget, an investment firm can proceed in one of two ways:

- establish a budget by portfolio or type of portfolio based on the estimated research requirement for each portfolio or type of portfolio, in order to enable decision-making thereof, the sum of which will constitute the overall budget (bottom-up approach)
- establish an overall budget based on the investment firm's estimated research requirement and apportion it by portfolio using a predefined allocation formula (top-down approach).

In every case, the investment firm's research payment account is funded from the overall research budget (cf. section 3).

- **The budget determination process must be as rigorous as it is comprehensive**

Where the budget is defined not for each portfolio or type of portfolio, but from an overall perspective of all portfolios under management, investment firms must put in place a sufficiently rigorous budget process so that the fairness of the allocation by portfolio or type of portfolio can be checked.

One approach could be to determine this overall budget by breaking it down into major categories of research service. The degree of granularity will then depend on the diversity of investment strategies within the portfolios under management. For example, a research budget could, at minimum, be broken down into categories of research (macro research, single stock research including quantitative research, SRI research, etc.) or by asset class (small caps, mid caps, government securities, credit, etc.).

To help it assess a forecast budget of necessary expenditure within these main categories, an investment firm could, for example, refer to an analysis of expenditure incurred during the prior period (or over a historical average). The investment firm could also, where applicable, take other factors into account, including in particular:

- expected changes in the level of assets under management in each of the portfolios concerned;
- foreseeable market events;
- planned changes in portfolio investment strategies.

In all cases, it is up to investment firms to quantify expenditure based on what is needed, ie. To provide investment services in the client's best interests, taking the factors into account as considered pertinent in this regard.

- **Establishing a budget at least on annual basis,**

Article 13 appears not to be prescriptive as to the frequency with which budgets should be established. However, it arises from paragraph 1(c)(ii) of this article that *ex post* client reporting must be undertaken annually, which suggests that budgets should be established at least annually, though there is nothing to prevent managers and their research providers opting for more frequent reporting. Nevertheless, where the respect of clients' interests is justified, under duly justified and documented circumstances, the possibility of the budget being set on a multi-year basis

## **B. Budget monitoring**

Investment firms must regularly assess the quality of the research purchased from each provider based on "robust quality criteria and its ability to contribute to better investment decisions"<sup>14</sup>. Pursuant to paragraph 6 of Article 13, assessment and monitoring of the research budget is placed under "senior management oversight to ensure it is managed and used in the best interests of the firm's clients".

Investment firms are thus expected to put in place a robust and independent process for assessing the quality of research purchased, based on a previously established written policy (cf. point 2.2) provided to clients<sup>15</sup>.

As such, while certain execution and research services might be provided by a single provider, the quality of those services must be assessed through two separate, independent processes to ensure that there is no correlation between transaction fees and research charges laid down in the Delegated Directive.

As regards research, the results of this assessment must be taken into account when assessing the overall budget for the following period: if, after assessment, it is established that a specific type of research or service has contributed little to reaching decisions in the best interests of clients, the investment firm must draw appropriate conclusions when allocating forecast expenditure and determining the budget for the following period. Conversely, the investment firm may also adjust the overall budget allocation if its investment strategies, and therefore its research requirements, change.

## **C. Budget revision**

Article 13 stipulates that research costs charged to client portfolios must be based solely on the budget. This means that no additional research costs can be charged to portfolios apart from those resulting from an increase in the budget under the terms laid down in this article.

In practice, however, information gathered by different services from investment firms providing portfolio management services tends to show that research requirements are relatively insensitive to marginal fluctuations in the level of assets under management or indeed of the markets.

The fact remains that, should an investment firm be faced with fluctuations of this type that are not marginal but significant, and hence give rise to an increased requirement to purchase research, it must initiate a budget review procedure under the terms laid down in paragraph 5 of Article 13, according to which investment firms must inform their clients in advance, unless they themselves bear the cost of such additional expenditure.

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<sup>14</sup> Article 13 1.(b)(iv).

<sup>15</sup> In accordance with paragraph 8 of Article 13.

## 2.2 Allocating the budget by portfolio

Paragraph 8 of Article 13 of the Delegated Directive stipulates as follows:

"[...] investment firms shall establish all necessary elements in a **written policy and provide it to their clients**. It shall also address the extent to which research purchased through the research payment account may **benefit clients' portfolios**, including, where relevant, by taking into account **investment strategies** applicable to various types of portfolios, and the approach the firm will take to **allocate such costs fairly** to the various clients' portfolios."

It thus emerges from this text that investment firms must allocate the research budget among their various portfolios under their own responsibility and based on a previously determined allocation policy that is documented and provided to clients.

In this regard, a number of principles could be developed which, while not mentioned in the Delegated Directive, appear to make good sense and could help a portfolio manager rationally allocate its overall budget by portfolio or type of portfolio:

- Taking into account the level of assets under management when allocating charges among portfolios appears to be a legitimate criterion.
- Research must be related to portfolios' potential investment universe. As such, the allocation of costs among portfolios must reflect any differences in the scope of potential investments that might arise from differences in the investment management agreements entered into with clients; the broader the scope, the more diverse the types of research those agreements might require.
- Research charged to a given portfolio might not be limited to research on the securities in that portfolio: investment, divestment and non-investment decisions also require the benefit of clarification that can be provided by a research note.
- The investment approach must also be taken into account: for example, stock-picking will, on the face of it, consume more research (especially single-stock) than index-based investment.
- Lastly, there is nothing to prohibit investment firms from agreeing preferential terms for charging research costs to some of their clients, provided that doing so is not detrimental to the interests of other clients. In which case, the investment firm will have to bear the cost of such a gesture of goodwill.

Finally, it would be considered that if an investment firm were to charge the cost of research exclusively benefiting discretionary portfolios to collective investment portfolios, it would not be acting in the best interests of unit holders of the funds it manages.

## 2.3 Agreeing and notifying clients about the research budget

Paragraph 1.(c) of Article 13 stipulates as follows:

"Where an investment firm makes use of the research payment account, it shall provide the following information to clients:

- (i) before the provision of an investment service to clients, information about the budgeted amount for research and the amount of the estimated research charge for each of them;
- (ii) annual information on the total costs that each of them has incurred for third party research."

Paragraph 5 of the same article stipulates as follows:

"The investment firm shall agree with clients, in the firm's investment management agreement or general terms of business, the research charge as budgeted by the firm and the frequency with which the specific research charge will be deducted from the resources of the client over the year. Increases in the research budget shall only take place after the provision of clear information to clients about such intended increases."

The aim of this section is to define the information to be provided at the onset of the relationship and the beginning of each period, as well as information to be provided at the end of each period (i.e. upon reviewing the quality of research received and the amounts paid by the investment firm for the portfolios it manages).

#### A. *Ex ante* information

As regards *ex ante* information, i.e. information provided before the investment service is rendered, the Delegated Directive lays down twin requirements that:

- the budgeted amount to be charged is agreed upon with a/the client;
  - a/the client is continuously informed, notably of any increases in the current budget over the period.
- **Client agreements and notification**

Client agreements can apply for a potentially long period (several years)<sup>16</sup>. For this reason, budgets to be charged to clients must be agreed between investment firms and their clients at the onset of the relationship, either in the general terms of business or in the investment management agreement. Budgets may be agreed in the form of either an amount or a percentage of assets under management, on an annual basis. Where the budgeted amount remains unchanged from one year to the next, the client need only be informed. However, if the budgeted amount changes, and in particular if it increases, the new amount should be covered by a new agreement with the client.

• **Information about increases in the research budget during the period**

In accordance with Article 13<sup>17</sup>, clients must be clearly informed of any increase in the research budget during the period that results in an increase in the individual research charge borne by each client. The information must include the amount of the increase as well as the foreseeable impact on the research charge to be borne by clients.

#### B. *Ex post* information

Information to be provided at the end of each period (*ex post*) must be based on actual expenses borne by each portfolio. There is no requirement for the individual information provided to clients to be broken down by type of service or by research provider; it need only relate to the total costs charged to each client for research<sup>18</sup>. However, investment firms are free to provide their clients with more granular information if they so wish.

#### C. Additional information upon request by clients

Upon request by its clients, where an investment firm operates a research payment account, it is required to provide a summary indicating<sup>19</sup>:

- providers paid from that account;
- the total amount paid to those providers over a defined period;
- the benefits and services received by the investment firm; and

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<sup>16</sup> Although the Directive only specifies that clients must be informed at the onset of the relationship, it is logical to communicate this information each year when the annual budget is set.

<sup>17</sup> Paragraph 5 of Article 13: “[...] Increases in the research budget shall only take place after the provision of clear information to clients about such intended increases.”

<sup>18</sup> Firms are only required to provide each client with a breakdown of total expenditure by service provider, not the share of each provider’s services allocated to each client.

<sup>19</sup> In accordance with the paragraph 2 of Article 13.

- how the total amount spent from the account compares to the budget set by the firm for that period, noting any rebate or carry-over if residual funds remain in the account.

This summary is drawn up by the investment firm for all its research expenses. The Delegated Directive does not require the summary to show only those expenses charged to the individual portfolio in question.

This summary must also be made available to the AMF.

#### **Obligation to provide clients with a written policy on research funding**

This policy must, at minimum, specify the following:

- ✓ the qualitative criteria against which the research is assessed
- ✓ where the research budget is set using the top-down approach, the formula used to allocate the research budget depending on portfolio strategy
- ✓ at the end of each period, the main characteristics of the process for reviewing the quality of research received



### 3. Operation of the various types of research payment account and commission sharing agreements under this new regulatory framework

#### 3.1 Operating and funding the research payment account (RPA)

Various types of research payment account can be considered:

- **Simple RPA model:** an account funded in line with the budget set in advance (ex ante) , with ad hoc costs – charged in addition to management fees – collected from clients in accordance with a frequency and methodology to be defined by the investment firm, and independently of the rate at which transactions are executed (e.g. provisioning fees at each portfolio valuation date and regularly deducting them from the outstanding amount).

- **RPA model based on a commission sharing agreement (CSA):** research costs are charged when transactions are executed by the execution intermediary on behalf of the investment firm, in addition to execution fees; the investment firm defines and subsequently manages the percentage of fees to be charged each time a transaction is executed such that the level of research fees charged is ultimately in line with the budgeted amount.

Whichever model is adopted, funds used to pay research providers are taken from this account, depending on the service quality review undertaken by the investment firm.

#### 3.2 Responsibility for research payment accounts

Paragraph 1 of Article 13 stipulates as follows:

“[...]”

(iii) the investment firm is held responsible for the research payment account;”

The Directive stipulates that investment firms remain responsible for research payment accounts at all times. It is up to investment firms to determine whether, for operational reasons, they wish to operate one or more research payment accounts.

Furthermore, paragraph 7 of the same article stipulates as follows:

“For the purposes of point (b)(iii) of paragraph 1, the investment firm may delegate the administration of the research payment account to a third party, provided that the arrangement facilitates the purchase of third party research and payments to research providers in the name of the investment firm without any undue delay in accordance with the investment firm’s instruction.”

The Delegated Directive specifies that investment firms remain responsible for their research payment accounts, both for their funding – irrespective of the model adopted – and for payments made from them to research providers. In this regard, it is up to investment firms to ensure that the legal security of accounts held with their intermediaries is satisfactory.

Furthermore, the Directive explicitly states that investment firms may delegate the purchase of and payment for research to an external provider.

Lastly, the Directive specifies that research payment accounts are the responsibility of investment firms. It is therefore up to investment firms to decide whether they wish to operate one or more research payment accounts<sup>20</sup>.

<sup>20</sup> Where the account is funded under a CSA, the investment firm might consider that it needs to put in place more than one such agreement. Indeed, holding a single commission sharing agreement with a single intermediary could lead an

### 3.3 Commission sharing agreements still authorised under certain conditions

Paragraph 3 of Article 13 stipulates as follows:

“Every operational arrangement for the collection of the client research charge, where it is not collected separately but alongside a transaction commission, shall indicate a separately identifiable research charge and fully comply with the conditions in paragraph 1, points (b) and (c).”

The Directive explicitly clarifies that the collection of research fees via a single payment in the form of a transaction commission is authorised insofar as all the conditions set out above are met, and particularly:

- that a research payment account is set up, funded by research charges collected from clients, the administration of which may be delegated to a third party, but for which the investment firm remains responsible;
- that execution commissions are distinctly identifiable from research charges;
- that transparency is maintained;
- that there is no correlation between transaction volumes and research charges;
- that a budget is drawn up and adhered to<sup>21</sup>.

### 3.4 New operating arrangements for commission sharing agreements

The provisions of the Delegated Directive appear not to be incompatible with commission sharing agreements. However, operational processes for monitoring expenses charged under commission sharing agreements will, in particular, need to be adjusted as follows:

- Execution fees will need to be charged to client accounts separately from research charges.
- Research costs will need to be charged in accordance with the budget process set out above. In particular, this means that mechanisms must be in place to ensure that no further research fees are charged to portfolios once the budgeted amount is reached<sup>22</sup>. Should there be a surplus in the research payment account relative to the budget at the end of a period, pursuant to paragraph 5 of Article 13 the investment firm should have a process to rebate those funds to the client or to offset them against the research budget and charges calculated for the following period. Conversely, if the budget is not reached, with the exception of when an investment firm establishes that its budgeted research requirement falls short of expectations, the balance on the account should be paid to the research providers concerned, by direct payment excluding brokerage fees, and potentially applied to clients.

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investment firm to have all its transactions executed by a single broker so as to fund the RPA (which might not be desirable as regards best selection). However, if the investment firm considers it desirable, to offset this effect it may transfer all payments to a single account centralising all available funds. Readers are reminded that this consultation does not address the tax implications of the new system, in particular where a single account is used.

<sup>21</sup> The total amount of research charges received may not exceed the research budget.

<sup>22</sup> Where applicable, rebalancing measures could be put in place if new investment management agreements also benefiting from the research were entered into once funding of the research payment account had been suspended.

Annex: Diagram – Funding research via a research payment account

