AUTORITÉ DES MARCHÉS FINANCIERS

AMF

Feedback from the public consultation on the new rules for the funding of research by investment firms under MiFID II

Background and regulatory framework of this consultation

Given the forthcoming transposition of the revised markets in financial instruments directive (MiFID II)[1] and the Delegated Directive[2] published on 7 April 2016, the AMF launched a public consultation[3] from 12 September to 28 October 2016 to open a dialogue with industry participants and industry representatives on the principles for the operational implementation of the new rules governing the funding of research. The AMF's aim was twofold: explain its understanding of the new framework and reconcile this understanding with the operating constraints of the various operators.

The provision to investment firms, and particularly firms that offer portfolio management services, of research documents published by financial intermediaries or research firms will now fall under 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 interest.

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 research by third parties 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 investment firm's own resources; or
- Payment charged to the investment firm's clients (with their consent) but taken from a separate research account monitored by the investment firm, under certain operational and transparency conditions.

Number of responses and respondent profiles

The AMF received 44 responses from all types of stakeholders, of which more than a quarter came from abroad[4]: mostly on the buy side in the broadest sense of the term[5] (18) and sell side (8), as well as independent analysts and data providers. French and European industry representative associations also responded to this consultation in large numbers.

The AMF is considering the publication of a guide in 2017, after the European Securities and Markets Authority (ESMA) has finalised the level 3 work, to help industry participants navigate the implementation process of the new provisions.

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

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

[3] Available at the following address: http://www.amf-france.org/Publications/Consultations-publiques/Annee-en-cours.html

[4] This includes non-French operators, i.e. respondents whose parent company is foreign or operators representing transnational interests.

[5] This includes management companies, their representatives and institutional investors.

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1. General feedback

This consultation and the proposals made were overall well received by respondents.

In addition to the content of the new rules and the operational requirements, respondents made a number of comments on the scope of these new rules, criticised the absence of a proportionality clause in the level 2 text and highlighted the need for uniform application of convergent rules.

Secondarily, many respondents also wanted to establish an identical tax system for research provided by an independent research provider that is actually subject to VAT and by a provider that also offers order execution services (in which case the option selected by each provider determines the applicability of VAT).

1.1. Extending requirements to collective management

The AMF explained in its consultation that, in accordance with the scope of MiFID II, these new provisions only apply to the provision of research to investment firms subject to MiFID II in connection with their individual management and investment advisory services. These new provisions do not therefore apply to the provision of research to management companies in connection with their collective management services. 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 advisory services[6].

However, a small number of respondents were critical of the AMF for not choosing to extend the scope of these new rules to collective management. Some respondents stressed that it might be difficult for management companies that provide discretionary and collective management services to differentiate between a research service that benefits discretionary management and a research service that benefits collective management. Some respondents also explained that, for operational convenience, they intended to apply these requirements to their collective management service, while others stated that they would not be able to apply all the provisions to collective management, in particular the requirement to agree on a research budget with each client and therefore potentially with each holder.

The AMF confirms that it does not intend to go beyond the requirements of MiFID II, which would amount to considerable gold-plating of the European rules. Extending the scope could also put the Paris marketplace at a competitive disadvantage relative to other European markets that might make a different choice. Management companies may decide whether or not to apply these new rules to collective management, insofar as the client has been clearly notified in advance. The client will still have to consent, and this will entail compliance with the obligation to fund the budget, which will potentially have an impact on the net asset value of the fund to be managed to comply with the principle of equal treatment of holders. Furthermore, the budget allocated to discretionary management clients cannot include collective management research costs and vice versa.

Lastly, regarding investment services subject to these new rules, one respondent proposed limiting the application of these new provisions to investment firms that have not identified themselves to their clients as independent. Such an approach would seem to limit the scope of the provisions, which is not covered under the Delegated Directive.

[6] 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.

While the framework provided for in MiFID II does not extend to collective management, management companies are free to apply it to this activity should they wish to do so. In that case, management companies must consider the operational procedures for applying these provisions to their collective management services. In any event, research charges collected from discretionary management clients must not fund research used to provide collective management services, and vice versa.

1.2 Absence of proportionality in the Delegated Directive

Many buy-side and sell-side respondents criticised the absence of proportionality in implementing these new provisions. However, as this point has not been addressed at the political level, the Delegated Directive does not provide for implementation of a threshold for the smallest investment firms.

In the past, the AMF had been able to adapt the application of unbundling rules to management companies[7] whose intermediation fees were more than EUR 500,000, but this was a purely national system and was in no way provided for at the European level by a higher-level law, as is now the case under MiFID II[8].

Similarly, a number of respondents called for these provisions to be subject to transitional arrangements. However, it would seem difficult to grant transitional arrangements only at the national level when they are not allowed at the European level by the level 2 text.

The Delegated Directive does not therefore provide for proportionality in the provisions on the funding of financial analysis, in contrast to other articles in the same directive. Furthermore, the Delegated Directive does not enable national authorities to establish exemption thresholds or transitional periods in the context of the transposition of the European texts at a national level. The rules will therefore come into full effect on 3 January 2018.

1.3. Convergence and harmonised application of the rules

Respondents stressed the importance of a harmonised European approach. The AMF notes that it is actively taking part in the level 3 discussions underway within ESMA and that it intends to monitor any clarifications ESMA may provide[9].

Some respondents, in particular from abroad, also highlighted certain operational difficulties due to the incompatibility of certain European and U.S. rules. U.S. regulations would prevent U.S. broker-dealers from receiving direct payments from investment firms for the research provided, while MiFID II encourages investment firms to pay for research directly and not through execution fees.

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[7] Article 314-82: "[…] If the asset management company uses investment decision aid and order execution services and if the intermediation fees for the previous year came to more than EUR 500,000, it shall compile a document entitled "Report on Intermediation Fees" that shall be updated as needed. The report shall specify the terms and conditions on which the asset management company used investment decision aid and order execution services, along with the breakdown […]".

[8] In general, the European Commission tends to apply the principle of proportionality to rules of organisation and not to rules of conduct. This principle of proportionality is also explicitly provided for in the texts, as is the case for deposits of client funds in the Delegated Directive. Article 4, paragraph 3 states: "Member States shall require that, where investment firms deposit client funds with a credit institution, bank or money market fund of the same group as the investment firm, they limit the funds that they deposit with any such group entity or combination of any such group entities so that funds do not exceed 20% of all such funds. An investment firm may not comply with this limit where it is able to demonstrate that, in view of the nature, scale and complexity of its business, and also the safety offered by the third parties considered in the previous subparagraph, and including in any case the small balance of client funds the investment firm holds the requirement under the previous paragraph is not proportionate".

[9] A number of Questions and Answers are already available on ESMA's website at https://www.esma.europa.eu/press-news/esma-news/esma-updates-mifid-ii-qa-investor-protection

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

2.1 Criteria defining services that can be assigned to the research budget

Content of the consultation:

In accordance with clause 28 of the Delegated Directive, the following two conditions must be met for a document or service to be eligible as research:

(i) The document or service must be research material or services concerning one or more financial instruments or other assets, or the issuers or potential issuers of financial instruments, or research material or services closely related to a specific sector or 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 a substantiated 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 its clients.

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

Respondents, particularly on the sell side, reacted positively to this definition and supported the AMF’s approach of strictly limiting, for the purposes of the Delegated Directive, application of this definition to MiFID II, without extending it to other texts, such as the market abuse regulation.

A number of respondents stressed that the investment firm itself should determine the eligibility of the research, based on the service provided to it and consistent with its investment strategy(ies), and in particular it should assess the originality criterion. Respondents also said that the definition should cover both written publications and services. For example, phone calls in which trade ideas are given and financial analysis reports should not be excluded. The AMF agrees and does not intend to limit the definition of research to a specific form of documentation. Lastly, several respondents had questions about how to classify intra-group research. It would make sense to take the same approach to intra-group research and for it to be analysed against the above-stated criteria.

In contrast, another respondent considered that only “independent” research should be eligible for the new funding procedures. However, at this time it does not appear that the Delegated Directive requires such a criterion.

Lastly, some respondents questioned the possibility of receiving free research in the testing phase, in particular unsolicited research. Investment firms are responsible for determining whether this is a minor non-monetary benefit and, if not, for deciding whether to pay for the service or to stop receiving it.

Investment firms are also responsible for establishing procedures for tracking the quality of the research received and for implementing any support tools they believe are appropriate. Generally speaking, the internal rating system investment firms use to assess a research service, such as the “broker vote”, should not be excluded.

Investment firms are therefore responsible for conducting their own analysis of the services and documents received, so as to determine whether they meet the definition of research.

2.2. Items excluded *de facto* from the research budget

Content of the consultation:

In accordance with current provisions[10], the costs of certain services cannot be charged to the research budget, in particular:

- the provision of goods or services that correspond to resources that the portfolio management should have for its programme of activity, such as administrative or accounting management, the purchase or leasing of premises, or compensation for staff;

- the provision of services for which the asset management company receives a management commission.

In 2007, the AMF published an instruction setting out a non-exhaustive list of these 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 for its programme of activity. In light of the new texts, the AMF is considering whether to update the list of prohibited services specified in this instruction[11].

A number of buy-side and sell-side respondents were in favour of updating the list of services that are "prohibited" within the 2007 meaning and would therefore not be fundable through research charges. Several respondents suggested removing subscriptions from this list. The 2007 list specified that "subscriptions to publications" could not be covered. While, at the time, subscriptions to data flow services may not have been considered to be investment decision support services, one possibility under MiFID II could be to allow investment firms to decide whether the publications, regardless of their distribution channel, meet the definition of whereas clause 28[12].

Certain goods or services required for the management company's programme of activity are therefore not eligible as research within the meaning of the Delegated Directive and cannot be charged to the client. The AMF, in transposing the Delegated Directive, will update the 2007 list of prohibited services.

2.3. Minor non-monetary benefits

Content of the consultation:

MiFID II excludes from the regime in Article 13 of the Delegated Directive all minor non-monetary benefits that may be retained by the investment firm with no additional requirements, as they present a low conflict-of-interest risk. The Delegated Directive sets out an exhaustive list of non-monetary benefits[13] that

[10] Article 314-83 of the AMF General Regulation.

[11] AMF Instruction no 2007-02 included in the annexes.

[12] Or are minor non-monetary benefits.

[13] Article 12 of the Delegated Directive states: "[...]

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;

can be considered minor. Clients must be informed, if only in generic terms, of the existence of such benefits.

Insofar as, in the consultation, the AMF simply reiterated the exhaustive content of the list of minor non-monetary benefits specified in Article 12 of the Delegated Directive, respondents had no comments on the content of the provisions. They paid particularly close attention to the relationship between minor non-monetary benefit with regard to macroeconomic research discussed in point 2.4.

One respondent called for clarification on the services that might fall under paragraph 3(e). This paragraph does in fact leave the national authorities some room for interpretation as it states that "other minor non-monetary benefits which a Member State deems capable of enhancing the quality of service 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" qualify as acceptable minor non-monetary benefits. This point will be further explored in the transposition of the Delegated Directive.

2.4. Application of the definition to certain specific documents or services

A. General information

Content of the consultation:

The AMF raised the question of whether general information, such as journalistic content, can be considered as research and thus funded through the research budget. Based on paragraph 3(a) of Article 12, "generic" information about a financial instrument or an investment service can be considered a form of "acceptable minor non-monetary benefit" and, as such, general information cannot therefore be charged to the investment firm and the investment firm cannot charge its clients for general information.

Respondents had no specific comments on this point.

B. Minor non-monetary benefits and wide dissemination criterion: the macroeconomic research example

Content of the consultation:

To be eligible for the proposed arrangements, macroeconomic research must meet the research definition criteria set out above. In particular, it must be original and serve to support investment decisions.

Questions may nevertheless arise for macroeconomic research disseminated 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 impairing compliance with its duty to act in the best interests of the client.

Respondents paid particularly close attention to developments on the issue of minor non-monetary benefits with regard to macroeconomic research. Some buy-side and sell-side respondents were opposed to this approach: one respondent therefore considered that any document or service, regardless of its form or dissemination, cannot qualify as a minor non-monetary benefit simply because its production and

(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 State deems capable of enhancing the quality of service 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".

distribution are not valued by clients. Another respondent considered that this automatic qualification would give fund managers an excuse to take a broad view of minor non-monetary benefits and thus to opt out of the regime. Two respondents relied specifically on the concept of "substantive" within the meaning of clause 29[14], which allows investment firms to determine what qualifies as research and what is a minor non-monetary benefit because it is not substantive.

In contrast, other mostly buy-side respondents commented favourably on and even defended a broad and flexible interpretation of the concept of minor non-monetary benefit. Were such an approach to be taken, it would be up to the investment firm to conduct this assessment based on the services provided to it and its investment strategy. This concept could therefore vary from one investment firm to another.

One respondent expressed its wish for greater certainty on this concept of minor non-monetary benefit. Another respondent suggested introducing a materiality threshold to measure a document's level of dissemination and thus the extent to which it is minor. However, this approach would introduce a degree of rigidity specific to the French market, which would not be desirable. One respondent also suggested that, with regard to the wide dissemination criterion, any open-access research or research whose access is controlled solely for the purpose of identifying users (website with an email address login and a widely-distributed password) be considered a minor non-monetary benefit.

It is up to the research provider to quote an *ex ante* price for the research provided. In the absence of a price quote and in accordance with its policy, the investment firm shall be responsible for assessing and then deciding whether the macroeconomic research document received is a minor non-monetary benefit.

C. Commercial services

Content of the consultation:

Regular business contact between investment firms and their market intermediaries, which propose trade ideas, could qualify as supporting investment decisions. Consequently, the same approach can legitimately be applied to such contact as that applied to research. As such, the definition criteria must be applied and verified by investment firms to ensure that the service provided does indeed fall within the definition of research.

Certain buy-side and sell-side respondents that endorsed the AMF's analysis explained that regular contact between investment firms and market intermediaries qualifies as supporting investment decisions. It was also suggested that, to assess certain specific services, investment firms would have to assign a rating to their research providers during the review process. Another respondent argued that it would be impossible to perform individual verifications of the content of the service, except by preparing individual reports, which seems disproportionate. It does in fact seem disproportionate to perform an individual service-by-service evaluation; seeking the assistance of an intermediary within the business relationship to determine what is or is not research can therefore not be ruled out.

One respondent believed that clarifications were needed to identify what types of commercial services would be targeted. Nevertheless, there are two reasons for which it may not be advisable to establish an exhaustive list of services. First, an exhaustive list would leave little room for an individual assessment of the services provided and their quality. Second, such a list would necessarily be static and would not allow for changes based on market practices.

[14] Whereas clause 29: "[…] In addition, non-substantive material or services consisting of short term market commentary on the latest economic statistics or company results for example or information on upcoming releases or events, which is provided by a third party and contains only a brief summary of its own opinion on such information that is not substantiated nor includes any substantive analysis such as where they simply reiterate a view based on an existing recommendation or substantive research material or services, can be deemed to be information relating to a financial instrument or investment service of a scale and nature such so that it constitutes an acceptable minor non-monetary benefit".

Lastly, one respondent suggested that, from its standpoint, regular contacts do not constitute research but are sales pitches for which there should therefore be no charge or for which the charge should be included in the service actually received as a result of the business service. It could in fact be said that such contacts are sales pitches, since they support a research document that is moreover produced, and are part of a comprehensive service. Investment firms are free to differentiate the pure research service (excluding business services) in their payments and thus to pay for that portion only of the service provided.

Investment firms are responsible for determining whether the service received is substantive based on robust criteria that have been previously established in their internal policies.

D. Corporate access

Content of the consultation:

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.

It was also suggested that a distinction be drawn between:
- straightforward introduction without provision of a service of an intellectual nature similar to a "concierge" service, for which there would be no charge if it were to meet the definition of a minor non-monetary benefit or which would conversely be paid for by the investment firm out of its own funds.

- introduction accompanied by the provision of a service of an intellectual nature such as 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: an enhanced corporate access service could be considered research and could be funded by the investment firm's client from the research budget.

Many buy-side and sell-side respondents supported this approach. One respondent placed a particular emphasis on the importance of this type of event, which is necessary to enable issuers and fund managers to meet and also critical for smaller and niche operators, as these meetings represent real funding opportunities.

Certain respondents considered that the concierge service must be covered by the minor non-monetary benefit regime. While the AMF also believes that the concierge service could be a minor non-monetary benefit, this possibility is nevertheless governed by whereas clause 30 of the Delegated Directive whereby "any non-monetary benefit that involves a third party allocating valuable resources to the investment firm shall not be considered as minor and shall be judged to impair compliance with the investment firm's duty to act in their client's best interest". One respondent also suggested that, if the investment firm does not initiate the meeting, the corporate access service could be qualified as a minor non-monetary benefit. However, the Delegated Directive makes no distinction based on a "who initiated" criterion. It does not therefore seem possible to draw such a distinction.

Lastly, a number of respondents were strongly opposed to the approach proposed in the consultation on the grounds that the value added of the intellectual service received should be identified separately.

On this issue in particular, it is worth stressing the importance of ESMA's current work in order to promote a harmonised approach among all European regulators.

It may therefore be preferable to draw a firm distinction between a pure concierge service and an intellectual service. Investment firms would therefore pay for a concierge service directly, unless it is considered a minor non-monetary benefit. For an intellectual service more specifically, insofar as the investment firm, in accordance with its internal policy, determines that it is a research service, it could either bear this cost itself or pass it on to its end clients.

3. Operation of the research budget

3.1. Arrangements for defining and monitoring the overall research budget

A. Establishing the research budget

Content of the consultation:

- **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.

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.

- **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, i.e. 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 an annual basis**

However, under paragraph 1(c)(ii) of this article, *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 from opting for more frequent reporting. Nevertheless, where justified by respect for clients' interests, under duly justified and documented circumstances[15], the possibility of the budget being set on a multi-year basis could be allowed.

Respondents had no specific comments on these issues and were generally supportive, in particular of the option to establish either a *bottom-up* or *top-down* budget.

B. Budget monitoring

Content of the consultation:

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"[16]. Pursuant to paragraph 6 of Article 13, assessment and monitoring of the research budget are 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 provided to clients[17].

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.

Respondents had no specific comments on this point.

C. Budget revision

Content of the consultation:

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 AMF staff 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.

[15] Assuming "equity" management with little portfolio rotation, a multi-year budget could smooth research costs over several rotation cycles.
[16] Article 13.1(b)(iv).
[17] In accordance with paragraph 8 of Article 13.

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 revision 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.

Respondents had no specific comments on this point.

3.2. Allocating the budget by portfolio

Content of the consultation:

Investment firms must allocate the research budget among the 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 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 to 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 that case, the investment firm will have to bear the cost of such a gesture of goodwill.

- **General principles**

In general, investment firms must allocate the research budget among the various portfolios under their own responsibility based on a previously determined allocation policy that is documented and provided to clients.

Buy-side respondents welcomed the clarifications provided in the consultation regarding budget allocations and the flexibility investment firms would have in determining this allocation. Despite this flexibility, a number of respondents criticised the burdens these new provisions will impose. One respondent questioned the level of granularity required in allocating the budget to the various portfolios. On this point, fund managers should likely be offered sufficient flexibility to adapt the regulatory constraints to their business and the investment approach they take, while complying with the obligation to ultimately allocate the budget by portfolio. In this scenario, the fund manager is expected to be able to explain and justify any decision made.

A few buy-side and sell-side respondents indicated that they would like to be able to establish a research budget by investment strategy.

In this regard, it may be said that investment firms can establish a research budget by strategy insofar as the investment management agreements are similar and the clients share the same investment objectives.

- **Budget granularity**

Certain respondents expressed concerns about how to present the budget to the client, i.e. based on assets under management or basis points. Some respondents stated that, first, the only way to define the *ex ante* research budget is comprehensively[18] due to ongoing changes in the markets, the widely different levels of risk in the management agreements and the investment strategies associated therewith.

Second, with respect to commission sharing agreements, some respondents stated that it is not possible to provide, *ex ante*, a given client with an absolute or relative amount of the total research budget allocated to it, but that the client could be informed that its research consumption will be "correlated to its portfolio activity and could be informed of the percentage of the brokerage or turnover fee it is charged for portfolio buy and sell transactions that relates to research". One respondent also considered that, for commission sharing agreements, the transaction volume criterion could be used to inform the client of its research charge.

However, paragraph 2 of the Delegated Directive states that when the investment firm operates a research payment account, "the specific research charge shall not be linked to the volume and/or value of transactions executed on behalf of the clients". Furthermore, the Delegated Directive specifies that the research shall be agreed with clients[19]; at the very least, a maximum amount must therefore be specified.

It is important to note the obligation to establish a research budget by client and the requirement that the allocation thereof to one research provider or another not be linked to the volume and/or value of transactions executed with said research provider.

3.3. Agreeing and notifying clients about the research budget

A. *Ex ante* information

Content of the consultation:

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 the client;
- the client is continuously informed, notably of any increases in the budget over the period.

- **Client agreements and notification**

Client agreements can apply for a potentially long period (several years)[20]. For this reason, budgets to be charged to clients must be agreed between investment firms and their clients at the beginning 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[21], 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.

[18] That is, using a *top-down* approach.

[19] Article 13, paragraph 5.

[20] 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.

[21] 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".

A number of buy-side and sell-side respondents objected to the AMF's understanding that the research budget must be agreed with the client. Some respondents considered that, under Article 13.1(c)(i), merely notifying them of the budget is sufficient. However, paragraph 5 of Article 13 states that "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". While investment firms may merely inform their clients if the budget is increased during the year, it appears that they must in fact agree with clients when determining the budget. Some respondents questioned what form the client agreement should take. On this point, the suggestion is to apply the procedures previously agreed with clients in the investment management agreement or general terms of business.

All these provisions are applicable upon entry into force of MiFID II with no specific transitional arrangements.

The mandatory *ex ante* agreement on the amounts clients are charged for research may take the form previously agreed with clients in the investment management agreement or general terms of business.

B. *Ex post* information

Content of the consultation:

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[22]. However, investment firms are free to provide their clients with more granular information if they so wish.

Respondents had no specific comments on this point. However, it is worth noting that, while this mandatory *ex post* information may be provided to clients by any means, it must in any event be personalised for each client.

C. Additional information upon request by clients

Content of the consultation:

Upon request by its clients, where an investment firm operates a research payment account, it is required to provide a summary indicating[23]:

- 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
- 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.

Respondents had no specific comments on this point.

[22] The service provider is required only to provide clients with the breakdown of total expenses by service provider, but not the percentage of each service provider allocated to each client.

[23] In accordance with the paragraph 2 of Article 13.

4. Operation of the various types of research payment accounts and commission sharing agreements under this new regulatory framework

4.1. Operating and funding the research payment account (RPA)

Content of the consultation:

Two types of research payment accounts 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.

Respondents, notably on the buy side, reacted positively to these two types of research payment account and in particular appreciated the flexibility fund managers will have in selecting the type of account. Some respondents explained that, from their perspective, the “simple RPA” model seems easier to operate, at first glance, and also has the advantage that funds would not be transferred through an intermediary. In addition, some respondents supported the option given in the consultation to set up several RPAs. Conversely, one respondent considered that these mechanisms were of little interest due to their operational burden.

Some respondents raised questions about the status of the amounts deposited in the RPA. Once these sums are withdrawn from the client’s account, whether through periodic deductions or under a commission sharing agreement, they are considered to belong to the investment firm and not to the client.

Investment firms remain responsible for amounts collected as research charges even when the RPA is delegated to a third party.

4.2. Responsibility for the research payment account(s)

Content of the consultation:

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 account[24].

Respondents had no specific comments on this point.

4.3. Commission sharing agreements still authorised under certain conditions

Content of the consultation:

The Directive explicitly clarifies that the collection of research fees via a single payment in the form of a transaction commission is authorised insofar that 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[25].

A majority of respondents, in particular on the buy side, welcomed this clarification that commission sharing agreements could be maintained. One respondent criticised the maintenance of this practice as it believes the relationship between execution and research is still too strong under CSAs and it supports an approach in which research is paid for separately. Insofar as Article 13 of the Delegated Directive recognises the possibility of maintaining arrangements for collection linked to transaction execution[26], it seems neither desirable nor feasible to ban them at the national level. Several respondents also considered that the use of CSAs is severely hampered by the operational burdens caused by regulation.

CSAs are still authorised insofar as they comply with the requirements of Article 13 of the Delegated Directive, in particular as regards the prior determination of the budget.

4.4. New operating arrangements for commission sharing agreements

Content of the consultation:

The provisions of the Delegated Directive do not appear 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.

[24] 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 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. This consultation does not address the tax implications of the new system, in particular where a single account is used.

[25] The total amount of research charges received may not exceed the research budget.

[26] In accordance with paragraph 3 of Article 13.

- 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[27].

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.

One respondent stated that the execution intermediary should be able to adjust the rate charged for research in connection with order execution to avoid exceeding the maximum budget.

CSAs are still authorised but investment firms must establish processes for returning funds to clients if actual expenses are below budget. Conversely, if the budget is not reached, the balance should be paid to the research providers concerned.

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[27] 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.

AUTORITÉ
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Annex 1:

AMF Instruction no. 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.