UK allows bundled payments for third-party research and trading commissions

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Previously UK regulation, which came from the EU's revised Markets in Financial Instruments Directive (MiFID II), forced research to be paid for separately. The MiFID II rules were themselves stricter than the UK's prior regime. The MiFID II unbundling rules were intended to eradicate obscure charging structures, reduce disorderly spending on duplicative or low-quality research and mitigate conflicts of interest. However, they also had a detrimental effect on the EU and UK research industry, leading to a reduction in employment in the research sector and a material decline in the volume of research and companies covered.

The UK Financial Conduct Authority's (FCA's) new permissive approach is intended to address the situation. The changes also seek to ensure that UK investment managers can access research from other jurisdictions, particularly the U.S.

In this note we consider the FCA's new rules that allow for joint payments; similar changes that the EU is now intending to introduce; and the impact of these changes for U.S. broker-dealers who were affected by the restrictive MiFID II unbundling rules.

UK firms wishing to bundle their charges for third-party research and trading commissions should carefully examine the FCA's new rules and assess the implementation costs and benefits for their business model.

UK permissive regime allowing joint payments

Under the revised UK rules (revised COBS 2.3B.3), which have applied since 1 August 2024, third-party research is not an inducement if it is received in return for one of the following:

- Direct payment from a firm's own resources,
- Payment from a firm's separate RPA where the firm satisfies the conditions for operating the RPA, or
- Joint payment for third-party research and execution services provided the firm complies with the requirements for bundled payments.

Requirements for joint payments

The FCA requires certain processes and procedures to be in place before a firm may use joint payments. These are intended to mitigate against the re-emergence of the practices that led to the original introduction of the research bundling rules in MiFID II. The new rules require a firm that chooses to use joint payments to put the following operational procedures (COBS 2.2B.25) in place.

A written policy on joint payments

A firm's joint payments policy must describe the firm's approach to joint payments and how it complies with the FCA's rules. The policy must also describe the operation of the firm's governance, decision-making and controls for joint payments, including how joint payments are maintained separately from those for trade execution. If the budget (see below) is exceeded or if the budget is increased, the policy must also state what the firm will do and what information will be disclosed to the client, in those circumstances.

Arrangements detailing the methodology for how the research costs will be calculated and identified separately within total charges for joint payments

The FCA had originally proposed that a written agreement should be entered with research and execution service providers to establish this methodology. This was amended after consultation so that individual agreements are not required, providing firms with more flexibility to develop arrangements according to a broader range of market practices. The FCA did not agree with the feedback that it is not possible to have a separate price for research and has maintained that requirement. Firms must use the separately identifiable research charge of joint payments for research and execution services only to pay for research.

A research provider payment allocation structure

Firms must have a structure for allocating payments between different research providers. The structure must cover third-party providers of research and execution services, and independent research providers.

Establish operational procedures for administering the accounts for purchasing research using joint payments

A firm must ensure that the operation of such accounts do not affect its compliance with the FCA's rules, and it will be responsible for ensuring timely payments are made to research providers. The FCA's rules confirm that firms may delegate the operation of the joint payments account, but firms nevertheless remain responsible for ensuring compliance with the FCA's requirements. The FCA also allows firms using RPAs to delegate the administration of the RPA. However, in addition to firms remaining responsible for compliance with the FCA's rules, more stringent requirements apply than those for joint payments.

Set a budget for the purchase of research using joint payments

The budget must be based on the expected amount needed for third-party research for the investment services provided to the firm's clients; it must not be linked to the expected volumes or values of transactions executed on behalf of clients. This mirrors the FCA's approach to RPAs. The budget must be set at least annually, but the FCA has clarified that budgets can be considered more frequently.

The budget must be at a level of aggregation appropriate to a firm's investment process, investment products, investment services, and clients. It must not compromise a firm's ability to meet the requirements on fair allocation of costs and client disclosures. In its consultation, the FCA had considered aggregation levels and provided examples of similar investment strategies or groups of clients who would benefit from the same research. This aspect of the budget requirements has been amended by the FCA to take into account feedback, with the aim of providing flexibility for firms.

The FCA has also amended the requirement that disclosures of exceeded budgets should be made within the research budget period. Firms must now make that disclosure as soon as reasonably practicable.

Allocate the costs of research purchased using joint payments fairly between clients

The FCA has maintained the fair allocation rule, but has amended its guidance by adding that firms may allocate research costs at other allocation levels, provided they are appropriate to a firm's investment process, investment products, investment services, and clients.

Quality assessment

Firms must periodically, but at least annually, assess the value, quality and use of research purchased using joint payments and its contribution to the investment decision-making process. Firms must also ensure that the amount of research charges to clients is reasonable compared with those for comparable services.

The FCA had also proposed that firms should undertake a benchmarking of the prices paid for research services against the prices of relevant comparators. The FCA removed this requirement in the final rules, but included guidance to clarify that benchmarking of prices is a way in which firms can comply with the requirement to ensure that research charges are reasonable.

Client disclosures

Firms will be required to make various disclosures to their clients, including:

- The firm's use of joint payments for research, and if a firm also uses other options, how the firm uses the distinct types of payments.
- The main aspects of the firm's joint payments policy, or the policy itself. The information must be clear, fair and not misleading.
- The expected and actual annual costs to the client.
- The firm's most significant benefits and services received from research providers (measured by total amounts paid) and the types of research providers from which such services are purchased. The disclosure must be at a level of aggregation appropriate to the firm's investment processes, investment products, investment services and clients. The FCA had originally proposed that firms disclose the most significant research providers and given examples of the level of aggregation of "for similar investment strategies or groups of clients who benefit from the same research".

Where bundled payments are used, the FCA stated in its consultation paper that if it does not consider that firms have implemented the new option satisfactorily, it might issue further guidance or even more prescriptive standards.

Certain of the above requirements are similar to the requirements for payments using an RPA. For some firms, the operational complexity of complying with all of these requirements may mean that they will not implement joint payments, or at least not for some time.

UK revised acceptable minor, non-monetary benefits

The FCA has removed SME research as an acceptable minor, non-monetary benefit on the basis that this is no longer necessary with the introduction of additional payment options for investment research. Short-term trading commentary that does not contain substantive analysis, and bespoke trade advisory services "intrinsically linked" to the execution of a transaction in financial instruments have been added (new COBS 2.3A.19(5)(l)). The other types of research falling within this exemption have been maintained, namely, FICC research, openly available research, research by independent providers, trial basis research and pre-issuance research.

Delayed benefit for AIFMs and UCITS managers

The FCA has not yet extended the permission for new joint payment rules to AIFMs and UCITS managers. Nor do the changes to the acceptable minor, non-monetary benefits apply to these managers. The FCA states that it intends to make joint payments available to these firms. However, it will consult on the detailed changes in Autumn 2024. This lack of alignment on the rules for UCITS managers and AIFMs is likely to discourage some firms from taking up the new payment option as it would entail different operational procedures to be implemented across a firm's business.

Research payments and best execution

Best execution requirements oblige investment firms to obtain the best possible result for their clients when executing client orders. The FCA has confirmed that research services are not a factor in assessing best execution (new COBS 2.3B.29). In its policy statement, the FCA stated that the best execution rules apply unchanged. The FCA has also kept its guidance that a firm must not enter into arrangements for the receipt of or payment for research that would compromise its ability to provide best execution (COBS 2.3B.24). The best execution rules applicable to AIFMs and UCITS managers also continue to apply unchanged (COBS 11.2).

What's next?

The FCA will be considering the broader research investment regime in the near future, including looking at access to investment research for retail investors, clarifying other aspects of the regime and reviewing the rules on investment research in the context of IPOs. It will also seek to address wider industry concerns such as corporate access, FICC macro-economic research, trial periods, and the definition of research.

EU following the UK on permitting joint payments

The EU's provisionally agreed Listing Act Directive will, once enacted, remove the SME market capitalisation threshold entirely and allow EU firms to choose whether to make joint or separate payments for third-party research and execution services. Similar requirements to the FCA's would apply where a firm opts for joint payments. However, the EU's requirements are lighter touch than those of the FCA. For example, the EU do not require a structure for the allocation of costs, a budget nor an approach for the allocation across clients of the costs of research purchased through bundled payments.

The EU's provisionally agreed Listing Act Directive will also introduce a new exemption for short-term trading commentary, similar to that included by the FCA, and explicitly clarify (as the FCA did in 2021) that independent research providers are exempt from the research inducements rules. Independent research must, however, be included in the EU investment firm's annual quality assessment.

EU member states must transpose the Listing Act Directive into national laws by 18 months from date it enters into force. The precise timing is unknown until the Directive is published in the Official Journal of the European Union.

To encourage more research on SME's, the EU's Listing Act Directive provides for the establishment of a framework for issuer-sponsored research based on a code of conduct. ESMA is mandated to develop technical standards to establish the code, taking into consideration existing member state codes that are widely adhered to. This may include, for example, the 2022 AMAFI-AFG-SFAF charter on sponsored research (AMAFI / 22-44) which arose out of calls in 2020 by the French regulator, the AMF, for an industry-led code to be developed. Only research compliant with the EU-level code can be labelled as "issuer-sponsored research" and investment firms will need to

implement organisational requirements to ensure their compliance. In addition, issuers paying for issuer-sponsored research will be able to make the research public via the European single access point, which ESMA is mandated under separate legislation to establish by 10 July 2027. These initiatives mirror the UK's Investment Research Review's recommendation for a voluntary industry-led code of conduct on issuer-sponsored research.

Impact on U.S. broker-dealers

Following the FCA's rule adjustment to allow joint payments, U.S. broker-dealers may now once again utilise an exemption from the Investment Advisers Act when providing research to UK asset managers. U.S. broker-dealers, who are a major source of broking services across Europe, benefit from an exclusion from regulation under the U.S. Advisers Act if any investment advice they provide is "solely incidental" to their brokerage business and they receive no "special compensation" for providing the advice. MiFID-compliant hard-dollar payments for research would be considered "special compensation" under Section 202(a)(11)(C) of the Advisers Act, which would invalidate the exclusion, causing them to be regulated as investment advisers. Although some U.S. broker-dealers are additionally regulated as investment advisers or have affiliated investment advisers, others prefer to avoid fiduciary obligations and uncertainties of the application of the investment adviser regulation regime to the publication and distribution of research.

In response to the MiFID II unbundling rules, and in particular when the SEC's temporary relief expired in July 2023, U.S. broker-dealers that wanted to continue to provide research to UK and EU investment companies opted to become regulated as investment advisers, moved their research operations to an affiliate investment adviser or limited their research operations. In light of the FCA's rule change, brokers that opted to comply with the Advisers Act, or moved research operations to a registered investment adviser, may not now want to reverse such changes given the operational challenges associated with deregistration as an investment adviser and/or reintegrating research and broker-dealer operations into a single entity