

## **Regulator Assessment: Qualifying Regulatory Provisions**

**Title of proposal:** Extending new MiFID II investment research provision to non-MiFID firms

**Lead regulator:** FCA

**Date of assessment:** 28 February 2018

**Commencement date:** 3 January 2018

**Origin:** Domestic extension of EU legislation

**Does this include implementation of a Cutting Red Tape review?** No

**Which areas of the UK will be affected?** Whole of the UK

### **Brief outline of proposed new or amended regulatory activity**

Investment Research is material that implicitly or explicitly recommends or suggests an investment strategy in relation to one or more financial instruments or issuers, is intended for general distribution, and is either labelled as such or otherwise presented as objective or independent in nature.<sup>1</sup> This type of research is considered to be 'independent' by market participants. As such, existing FCA rules establish certain standards and arrangements that firms producing investment research should follow in order to ensure the objectivity of their analysts and avoid conflicts of interests in producing such material.

The Markets in Financial Instruments Directive (MiFID) II changes the rules in relation to investment research by introducing a new requirement for firms to maintain a physical separation between financial analysts and 'other relevant persons', as an additional measure to manage possible conflicts of interest. Under this provision, physical separation should exist unless it is not considered to be appropriate to the size and organisation of the firm, as well as the nature, scale and complexity of its business. In these circumstances, the firm is required to establish and implement appropriate alternative information barriers.

This builds on our existing rules requiring firms to manage conflicts of interest during the production and dissemination of investment research contained in COBS 12, as well as our overarching conflicts of interest rules in SYSC 10. These existing rules are designed to ensure the integrity of analysts that seek to produce material labelled as independent and provide confidence to investors who may use such material to inform their investment decisions that it is not inherently conflicted. For example, requirements for the production of investment

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<sup>1</sup> The legal definition is provided in the FCA's Handbook Glossary, see:  
<https://www.handbook.fca.org.uk/handbook/glossary/G602.html?starts-with=I>

research include that the analyst or relevant staff within a firm that produces it should not undertake personal transactions or dealings for the firm ahead of publication or before investors would have a reasonable opportunity to act on it (e.g. it prevents a firm from front-running recommendations). Existing rules also place limits on analysts sharing investment research with an issuer ahead of publication to reduce any risk of bias or undue influence by an issuer over the recommendation on a given security.

Ensuring common, high standards for investment research should help price formation and confidence in financial markets, and may improve efficiency in capital allocation by investors, including by those who make investment decisions on behalf of others, such as asset managers and investment advisors.

In line with our approach to implementing MiFID, we are extending the application of this new MiFID II rule to certain other types of firms who are not directly within the scope of MiFID II *if* they produce investment research. This extension covers third country firms, energy market participants (EMPs) and oil market participants (OMPs) who are exempt from MiFID under Article 2, and firms carrying out corporate finance business using the optional exemption provided by Article 3 of MiFID II. We have decided to extend this rule to these specific firms on the basis that they could be subject to the same conflicts of interest as firms carrying out MiFID business.

### **Which type of business will be affected? How many are estimated to be affected?**

As noted above, the change will affect third country firms, Article 2 EMPs and OMPs, and Article 3 MiFID-exempt firms carrying out corporate finance business.

In the cost benefit analysis (CBA) on which we consulted in CP16/29, we estimated that there are 15-20 firms classified as EMPs or OMPs, 565 firms carrying out corporate finance business, and approximately 120 third country firms operating in the UK to which these rules will apply. However, not all of these firms provide the investment research to which these rule changes apply. As such the number of firms impacted by our changes is likely to be considerably lower.<sup>2</sup>

<b>Price base year</b>	<b>Implementation date</b>	<b>Duration of policy (years)</b>	<b>Business Net Present Value</b>	<b>Net cost to business (EANDCB)</b>	<b>BIT score</b>
2016	3 January 2018	10	-0.1	0	0.1

### **Please set out the impact to business clearly with a breakdown of costs and benefits**

We sent out a questionnaire to around 5,000 FCA authorised firms in September 2015, asking for data to support its proposals for consultation in respect of all MiFID II changes. We followed this up with a second round of surveys. It then consulted on its proposals in a series of consultation during 2016 and 2017 on which it sought feedback on the proposals and the accompanying CBA.

In the section below we outline the costs to firms for the discretionary actions described above. The details presented below are drawn from underlying analysis conducted for the CBA

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<sup>2</sup> For example, based on questionnaire responses and further correspondence with contacted EMPs and OMPs, only two of the eleven firms who responded to us claimed to produce investment research.

in CP16/29 and which was finalised in PS17/14, and additional calculations undertaken for this impact assessment in relation to the familiarisation & GAP analysis costs.

#### *Familiarisation & GAP analysis costs*

We expect the impacted firms to read and digest the relevant changes and subsequently perform a gap analysis where they will familiarise themselves with the detailed requirements of new the new rules and guidance, and check their current practices against these expectations.

Based on assumptions on the time required to undertake this analysis and the cost of this time to firms, we estimate that firms will incur an average cost of £225<sup>3</sup> to undertake this work. In aggregate this indicates an overall cost of £0.1 million.<sup>4</sup>

#### *Remediation costs*

For the firms that do undertake investment research, as outlined above, we believe that they will not incur incremental costs from our new rules beyond one off familiarisation and GAP analysis costs.

Article 2 EMPs and OMPs, third country firms, and firms carrying out corporate finance business are already subject to the existing provisions in SYSC 10 and COBS 12 which require firms to use information barriers. As such, we consider that the changes are unlikely to have a material impact on the way that conflicts of interest relating to the production and dissemination of investment research are managed by these firms. MiFID II places an emphasis on physical separation as a tool firms should adopt in order to manage conflicts of interest around the production of investment research, *provided it is proportionate* for the firm to do so. Larger firms, such a third country banks, already have physical separation of relevant staff where it is feasible to do so, while smaller firms are still permitted to take alternative steps under MiFID II if physical separation would be unfeasible / disproportionate.

As noted in our cost benefit analysis in CP16/29, EMPs and OMPs are unlikely to produce investment research along the lines being considered here and as such would be unlikely to be impacted by the rules. Based on our original questionnaire to firms and follow up engagement with individual market participants at the time, we found that the few EMPs and OMPs that do produce investment research do not consider the new requirement to impose any additional changes to their current business practices. These firms cited the same reasons as noted in the preceding paragraph – e.g. larger firms routinely have physical barriers in place already, while smaller firms still have the discretion under MiFID II to implement alternative measures.

As such, we would not expect the new requirement to have any material impact on the potential compliance burdens for these firms, or to create any incremental remediation costs on either a one off or ongoing basis.

The changes proposed to extend MiFID II investment research provision to non-MiFID firms are expected to benefit consumers. For example, consumers may benefit from the additional layer of protection. The benefits to consumers and society are likely to exceed costs to firms. However, under the Act, benefits to consumers and society are out of scope for impact

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<sup>3</sup> This figure was not included in the original CBA in CP16/29, as we did not assess marginal 'familiarisation costs', but it reflects the FCA's decision to do so for the purpose of the Enterprise Act. The figure is based on an assessment of the number of pages of our CP, Policy Statement and new Handbook rules a firm's compliance officer would have to read, and the corresponding cost of their time to do so, which has been calculated using a common methodology as described in footnote 4 below.

<sup>4</sup> The assumptions used to estimate these costs have been derived from a research project on compliance costs that involved consultation with firms and trade bodies, discussions with vendors, a review of previous CBAs, internal FCA consultation, and desk-based research. To put a cost on time, we have sourced salary information for a range of occupations in financial services. Figures for large and medium firms are based on the 2016 Willis Towers Watson UK Financial Services Report. Small firm salaries were sourced from a systematic review of adverts on the website of Reed, cross-referenced with other publicly available sources. We add an allowance for overheads of 30% to all time costs to account for non-wage labour costs, as advocated by the HM Treasury Green Book.

assessments. These benefits are considered in our cost benefit analysis (CBA) prior to rule changes.

**Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.**

The relevant FCA consultation for these provisions is: FCA, September 2016, CP16/29: Markets in Financial Instruments Directive II Implementation – Consultation Paper III, <https://www.fca.org.uk/publication/consultation/cp16-29.pdf>

The relevant FCA policy statement for these provisions is: FCA, July 2017, PS17/14: Markets in Financial Instruments Directive II Implementation – Policy Statement II, <https://www.fca.org.uk/publication/policy/ps17-14.pdf>

The European Commission published an impact assessment alongside its initial proposal for MiFID II, which included the investment research proposals, which can be found here: [https://ec.europa.eu/info/file/33578/download\\_en?token=EMcmdZOS](https://ec.europa.eu/info/file/33578/download_en?token=EMcmdZOS)