Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: Extension of the MiFID II research and inducements provisions to collective portfolio managers

Lead regulator: FCA

Date of assessment: 20 December 2017

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

MiFID II restricts firms providing individual discretionary portfolio management (IPM)[1] services from receiving any material third party non-monetary benefits. However, investment firms will continue to be allowed to receive research without breaching these inducement rules as long as they pay for this research either:

a) Directly, out of the firm's own resources, or

b) From a research payment account (RPA) funded by a specific, separate charge to the firm's clients. The charge must be agreed and disclosed upfront to the client, be based on a research budget set by the firm and not be linked to execution volumes and values. An RPA is subject to further controls and accountability requirements on the firm.

We decided to apply similar standards to collective portfolio managers[2] (CPMs, including fund managers subject to the Undertakings for the Collective Investment of Transferable Securities (UCITS) Directive, and the Alternative Investment Fund Managers Directive), in line with the

[1] Individual portfolio management is a service whereby a firm acts on behalf of a client to manage investments in an account or portfolio on a discretionary basis under the terms of a discretionary management agreement. The firm will take investment decisions on behalf of that client to buy and sell financial instruments within a portfolio on their behalf, based on pre-agreed investment objectives or parameters set out in a management agreement, without needing the client's approval for each transaction. *Individual* portfolio management means that there is a separate management agreement with a client, and their assets remain separately identifiable, by contrast to collective portfolio management where multiple clients' assets are pooled in a single fund or scheme and managed to the same strategy.

[2] Collective portfolio management involves a firm pooling assets from a number of investors into a single scheme or fund structure, which is then used to buy and sell financial instruments (or potentially other assets) in line with a common investment strategy set for that fund. Individual clients have shares or units in the pooled fund reflecting the proportion of their invested funds and corresponding beneficial interest in the assets being managed.

scope of current domestic rules on dealing commissions, in order to address market failures established in successive supervisory and policy reviews conducted over the past few years. The changes should ensure that where the cost of research is passed through by a firm to the fund, it is fair and more transparent to the underlying investor and is subject to an appropriate degree of oversight and control by the firm managing the fund or collective portfolio.

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

Firms affected will include collective portfolio managers. We estimate there are 1,044 firms performing some type of CPM activity. Approximately two thirds of this population (670 firms) also have MiFID IPM permissions and perform both types of activity. This will mean they need to make changes to meet the MiFID II standard for their IPM business anyway. Based on responses to our firm survey, we assume 89%, or 596 firms, out of this population intend to read across the MiFID II inducement and research standards to their CPM business regardless of our discretionary decision, resulting in no incremental costs.[3] This leaves 11%, or 74 firms, of this 'mixed-scope' firm population who do not intend to do so and therefore would incur more material costs due to our final approach.

374 firms perform only non-MiFID CPM activity, and do not hold MiFID IPM permissions. These firms are not, therefore directly impacted by MiFID II changes in this area and are only affected due to our decision to extend these requirements. Combined with the 74 firms who do not intended to level up anyway, this provides a population of 448 firms who we envisage could incur direct material costs from our discretionary policy decision.

However, in finalising the rules, we decided to exempt collective portfolio managers whose main strategies involved private equity and venture capital business investing in either private companies or assets that are not MiFID financial instruments. Based on figures from a trade association, we estimate this excluded 137 firms from the above figures. This leaves a total of 311 CPM firms potentially impacted by these measures.

Price base year	**Implementation date**	**Duration of policy (years)**	**Business Net Present Value**	**Net cost to business (EANDCB)**	**BIT score**
2016	3 January 2018	10 years	-33.1	3.8	19.2

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 2 changes. It followed this up with a second round of surveys.[4] It then consulted on its proposals in a series of consultations during 2016 and 2017 on which it sought feedback on the proposals and the accompanying CBA.

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[3] Even if some of the firms we assume intend to level up may not have do so, we assess that any one off costs from extending MiFID II standards to their CPM business would be of minimal significance if made alongside the changes required to systems and processes changes for their MiFID II business. Most of these firms told us their use of research and commission management systems are currently integrated across their IPM and CPM activities, meaning the upgrades to meet MiFID II standards for their IPM business would largely read across to their CPM activity with marginal additional changes potentially needed purely for their CPM business.

[4] In total this yielded returns from 23 firms providing estimates of costs. Some of the firms responding to our survey reported a degree of uncertainty as to the precise legal interpretation of aspects of the requirements leading to difficulties in assessing the compliance costs likely to be incurred.

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 in CP16/29 and which was finalised in PS17/14.

Realised compliance costs for firms from extending MiFID II requirements to CPM business could fall within a large range due to the options as to how a firm may choose to pay for research going forward. In particular it will vary depending on whether firms choose to pay for research out of their own resources or use an RPA. At the time of producing the CBA we did not have reliable figures on the proportion of firms which would undertake each approach. To account for this, we have assumed that all firms will seek to use a form of research payment account (RPA), since this will be the costliest option in terms of compliance.

In practice, however, a sizeable number of firms may choose the alternative option of paying for research from their own resources, and so would not need to meet the more onerous requirements related to establishing a separate client research charge and using an RPA. For those firms any compliance and IT costs are likely to be lower than those described below meaning the total costs for firms provided here is likely to be an over-estimate once some firms adopting direct payments are taken into account.

The below costs do not include the actual cost of external research purchased by a firm. Pre-MiFID II, external research was often paid for through higher transaction fees being paid to brokers from CPM funds in return for research services received by the fund manager. Under our extended MiFID II rules, a CPM firms can pay for external research either via an RPA (as described above), or from its own resources. As we stated in our original CBA in CP16/29, we do not view the transfer of the existing cost of research itself between the fund and the fund manager, for example, as a cost of the reforms. To the extent these reforms may lead CPM firms to reduce overall net spending on execution or research services, we also assume this benefit would primarily be passed through to CPM investors, and so is not relevant to this assessment.

One-off costs

As noted above, based on the final policy decision we expect 311 firms may potentially be affected. However, we know that a number of firms within the population may also fully delegate the investment management to a MiFID firm. In this case, we assume a negligible one-off cost if the firm continues to delegate entirely, the management of their fund(s) will receive the benefit of MiFID II standards in this area with costs of minimal significance to themselves (since the firm to which they outsource will effectively be providing an IPM service that is directly subject to the MiFID II standards).

For the proportion of affected firms who do not delegate all of their investment management activity, for which we have estimated a range of 33%-76% of firms based on survey responses, costs will be incurred as a result of our discretionary proposals to require firms undertaking CPM activity to meet the MiFID II standard in this area.

We have estimated potential one-off costs based on data provided to us as part of the MiFID II CBA survey. From this data, we estimate an average one-off cost for an individual firm of £36,000. When combined with the firm population of 311 and accounting for our estimated range of firms who may delegate in full the management of their collective portfolios, we have calculated total one-off costs as a range between a lower estimate of £3.8m and a higher estimate of £8.4m.

Few firms provided any detailed breakdown or justification for what changes these costs will cover. However, based on our own analysis of the MiFID II requirements, we assume one-off costs would primarily include:

- revising internal governance and policies for establishing a research budget (although we expect most firms to already have some form of budget and process in place under our current rules), and to enable ongoing assessments of the eligibility of research and the quality of services to be received in line with new MiFID II standards and scope.
- upgrades to IT systems to ensure the firm can adequately track and review research usage and quality for this purpose, maintain an audit trail of payments made to providers for research services, and enable the deduction of separate research charges from portfolios (either directly or alongside transactions) to meet the RPA requirements.
- Establishing a written research policy, a new template for periodic research cost disclosures to clients, and the ability to produce more detailed disclosures on request.

Ongoing costs

For ongoing costs, our broad analysis of the impact is similar to the above for this sub-set of 311 firms. We assume material costs for the range of 33%-76% of firms who do not delegate all of the investment management of their collective portfolios to third parties. Conversely, for those that do delegate 100%, we assume zero direct costs.

Based on the same survey from 23 firms referenced above, we estimate an average ongoing cost for an individual firm of £19,000. Based on the same methodology, using the firm population of 311 and the range of possible delegation of all management activity, we calculate a range of total ongoing costs of between £2m and £4.5m.

Again, with respect to ongoing costs for CPM firms, few survey responses gave any specific detail on the nature of ongoing costs. However, ongoing costs are likely to be lower once one-off changes are made. We suggest the main ongoing costs will most likely stem from: additional IT maintenance and reconciliations of client research charges for the new RPAs; reviewing research policies and the research budget at least annually, including the fairness of cost allocation across funds or strategies to determine fund-level research charges; providing enhanced ongoing periodic disclosures to CPM clients; and regularly reviewing the quality of research provided in more detail than firms may perform under current rules.[5]

The changes proposed to further restricts inducement and research to CPMs are expected to benefit consumers. For example, consumers will benefit from improved investor protection as the changes remove potential influence on firms execution decisions due to valuable non-monetary benefits they receive from third parties. We expect returns to investors on their investments to increase as a result of removing the costs of research from transaction fees paid from investors' funds, and as a result of greater control over research costs. These 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 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 paper 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

[5] The level of additional ongoing costs could vary quite widely from firm to firm depending on their current approach to assessing third party research under our UK dealing commission rules. CPM firms who currently apply more rigorous controls and accountability over research paid for with dealing commission, in line with best practice, are likely to incur lower additional ongoing costs from adapting to meet the MiFID II standards.

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