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LES PROFESSIONNELS DE LA BOURSE ET DE LA FINANCE

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Bundesverband der Wertpapierfirmen

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The treatment of financial research

under Chapter 2.15 of ESMA's Technical Advice to the European Commission on MiFID II / MiFIR (ESMA/2014/1569)

We disagree with ESMA's proposal in Chapter 2.15 of its Technical Advice to the Commission on MiFID II and MiFIR[1] to include financial research within the scope of the provisions pertaining to "**non-monetary inducement**" provided for in Article 24(8) of the MiFID. Far from being a benefit which could divert a portfolio manager from its duty to act in the best interest of its clients, financial research is an investment service which the portfolio manager may choose to receive from third parties (including from an executing broker) in order to adopt informed investment decisions on behalf of its clients.

Despite the above, **even if it were to be considered an inducement** (an interpretation which we oppose), from an economic viewpoint financial research is not a benefit which the portfolio manager receives and retains, but rather an investment service which it passes on to its clients. In line with the provisions adopted by the European Parliament and the Council in Article 24(8) of the MiFID II, the mere fact that financial research is passed on to the clients turns it into a legitimate benefit, as it is the case with any other monetary and non-monetary benefit which a portfolio manager may receive from third parties. Within Chapter 2.15, §23, of the above mentioned Technical Advice, ESMA itself explicitly recognizes that that MiFID II is to be interpreted as prohibiting "*portfolio managers and firms providing independent advice to accept and retain inducement other than non-monetary benefits*" – it follows that any other benefit, including non-monetary benefits, have to considered legitimate inducements to the extent that they are passed on to the clients by the portfolio manager (or the firm providing independent advice).

Notwithstanding the above, **we do share the objectives** set forth by the European Parliament and the Council in MiFID II (Recital 74) as well as by ESMA in its final opinion to the European Commission (Paragraph 2.15) **to strengthen the current MiFID requirements concerning third party payments and benefits**.

Irrespective of the fact that financial research is or not an inducement that portfolio managers retain for themselves, we agree that the protection of the portfolio managers' clients cannot be entirely delegated to transparency requirements. An harmonized framework of organizational and conduct requirements should be introduced to foster compliance with the duty on portfolio managers to act in accordance with the best interest of their clients. To this end, we consider that portfolio managers should monitor, among other things, both the quality of third parties' research and the quality of the execution they receive from an executing broker which may provide them with financial research.

[1] http://www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf

Accordingly, we consider that, unless it is captured within the scope of the following safe harbor regime, a portfolio manager which charges its clients with the costs of the research it receives from third parties, has to comply with five fundamental principles:

1. The portfolio manager provides its clients with as much **transparency** as possible on these costs;
2. The total amount of the charges paid by a portfolio manager in return for third parties' research services is linked to the **quality of the research services** received;
3. The portfolio manager **informs its clients on the** methodology according to which third parties' research costs are allocated within their respective portfolios;
4. The portfolio manager establishes **internal administrative procedures** to allocate the above costs consistently with the methodology ;
5. The executing broker provides the portfolio manager with detailed information to allow the latter to comply with its **best execution** requirements.

Safe harbor

Due to the heavy administrative procedures in which compliance with the above five fundamental principles may result, portfolio managers should be able to abide by these principles through measures proportionate to their businesses and structure. A proportionate approach, that would follow the proportionality principle enshrined in EU treaties and reaffirmed in Recital 164 of MiFID, is of the outmost importance for smaller asset managers. As a matter of fact, whilst facing considerable difficulties in complying with the proposed regime, smaller asset managers are proportionally more active in SMEs financing compared to larger asset managers which have only a small portion of their assets invested in SMEs and, at the same time, a better capacity to absorb the organizational costs and burden of the new provisions.

To reduce the risk that the proposed regime may harm the financing of SMEs, we suggest introducing requirements specific to smaller portfolio managers, which would still be protective for their clients while less burdensome for them.

Transparency requirements pertaining to research costs and information to clients on the methodology **to allocate them**

Portfolio managers ought to be accountable for any cost they charge to their clients.

Among other things, they have to provide clients with detailed information on the cost of the financial research they receive from third parties and which they charge to their portfolios.

Irrespective of whether the financial research is received by the portfolio manager in return for:

- direct payments that it reflects in an increase of the advisory fees charged to the portfolios; or
- payments from a separate research account,

the portfolio manager should **inform its** clients on the **methodology it will use to allocate research costs** to their portfolios.

To this end, in line with the provisions in Article 24(4)(c) of the MiFID, portfolio managers should be required to provide their clients with the following information:

a. **Ex-ante** – detailed information as to the methodology to assess the research charges that will be deducted from their resources over the year and the frequency thereof;
b. **Ex-post** – detailed information on the actual costs that each client has incurred for third party research.

On the other hand, it would not be feasible to require a portfolio manager to get its clients agreement on a research budget. As a matter of fact, the portfolio manager is not able to assess in advance the costs of third parties' research it may need, in that:

- This cost is directly linked to the number of investment decisions (buy/sell/hold/abstain) it will take during the same period - each and every investment decision taken by a portfolio manager is based on a thorough analysis of the market situation in any given country as well as on the entire set of financial instruments which might be the object of investment; and
- The number of investment decisions it will take cannot be the object of an ex-ante decision, in that this number is strictly related to exogenous factors such as market volatility, micro and macro-economic perspectives pertaining to individual issuers, financial sectors and the market in general, the political situation of the country in which the issuer is established, etc..

If it were to comply with a budget (and the cost cutting pressure deriving from a budget requirement), a portfolio manager would rather tend to receive financial research on the most liquid stocks (namely those included in the financial indexes of the primary stock markets) to the detriment of financial research on SMEs. This is necessarily going to result in fewer, or no research coverage at all on SMEs listed on peripheral markets.

We are thus deeply concerned with the negative impact which the budget requirement recommended by ESMA is necessarily going to have on the cost of capital for SMEs as well as on employment and growth in the current situation of credit shortage.

Such a budget requirement would represent an issue for SMEs' financing even if the level 2 provisions to be enacted by the EU Commission would eventually allow for **Commission Sharing Agreements** (**CSA)**[2]. Indeed we very much favor CSAs in that they prove very useful and are nowadays widespread especially in cross-border transactions, where they facilitate payments for research supplied to large portfolio managers by analysts/brokers located in the various markets in which the formers carry out their activities while complying with the best execution rules. Still if the portfolio manager had to comply with a budget when allocating payments under these agreements, it would tend (once again) to favour financial research on the most liquid stocks, which would normally represent almost the totality (around 95%) of the financial instruments included in the portfolios under management. These circumstances make the local brokers/analysts' work less competitive and effective, and contributes to weakening further local SMEs' markets.

Moving from the assumption that a more than adequate level of protection of the clients' interest could stem directly from the above-considered supervisory framework, we encourage the Commission to substitute the clients' agreement on cost allocation for the research budget.

Organizational and conduct of business requirements - Paying for quality research and fair allocation of costs

Each and every cost paid by a portfolio manager to third parties on behalf of its clients should strictly reflect the quality of the services they receive.

Accordingly, portfolio managers should adopt internal administrative procedures to:

- Clearly assess their needs for third parties' research; and

[2] CSAs are mentioned in Chapter 2.15, §24, of ESMA's Technical Advice.

- Price research services on the basis of their quality, namely on their being original, capable of bringing value to investment decisions, having intellectual rigour and reaching meaningful conclusions.

By no means should a portfolio manager be allowed to condition research payments to research providers merely to the volume and/or the value of the transactions carried out on the financial instruments covered by the research (among other things, such a methodology would not allow the portfolio manager to remunerate “hold” recommendations or a piece of research which proved useful to keep its clients’ portfolio off specific investment instruments and/or markets).

More to the point, where financial research services are provided to a portfolio manager by an executing broker, they may well agree to make use of dealing commissions to pay for such services provided that they abide by the following requirements:

1. The portfolio manager and the executing broker have agreed in advance the proportion of the dealing commissions which is meant to remunerate the financial research, on the one side, and the execution services, on the other side;
2. The amount of the dealing commissions which is to remunerate financial research reflects the quality of the research services provided by the executing broker. These services may refer to the financial instrument which is the object of the specific transaction to which the dealing commission is linked and/or any other quality research services received by the portfolio manager within a given period of time;
3. The portfolio manager has established internal administrative procedures to allot the cost of third parties’ research into its clients’ portfolios in accordance with the allocation methodology.

<u>Best execution</u>

A portfolio manager who receives financial research from an executing broker should be in a position to clearly identify the cost of execution so as to ensure it abides by its obligation to provide best execution to its clients. To this aim, firms providing execution services should clearly disclose the amount of their trading fees or commissions which remunerate the execution services.

ESMA'S ADVICE (CH. 2.15)	PROPOSED TEXT
Investment research 7. The provision of research by third parties (such as firms executing orders or independent research providers) to investment firms providing portfolio management (or other investment or ancillary services) to clients should not be regarded as an inducement if it is received in return for:	*Investment research* 7. The provision of research by third parties (such as firms executing orders or independent research providers) to investment firms providing portfolio management (or other investment or ancillary services) to clients should not be regarded as an inducement if ~~it is received in return for~~: i. the research and execution fees paid by the investment firm amount to less than EUR 1.000.000 for the previous year, provided the following conditions are met: a. the investment research proves useful in the investment firm's decision-making process in respect to its portfolio management services rendered to its clients, and b. the investment firm provides its clients with annual information on the amounts paid for research and the providers to which these amounts are paid; or
i. direct payments by the investment firm out of its own resources (which they may choose to reflect in an increase to the firm's portfolio management or advice fees), or	ii. it is received in return for direct payments by the investment firm out of its own resources (which they may choose to reflect in an increase to the firm's portfolio management or advice fees), or
ii. payments from a separate research payment account controlled by the investment firm, provided the following conditions relating to the operation of this account are met: a. The research payment account shall only be funded by a specific research charge to the client. The specific research charge shall:	iii. it is received in return for payments from a separate research payment account controlled by the investment firm, provided the following conditions relating to the operation of this account are met: a. The research payment account shall only be funded by a specific research charge to the clients (which may be collected through fees of dealing commissions). The ~~specific~~ research charges

	• only be based on a research budget set by the investment firm for the purpose of establishing the need for third party research in respect of investment services rendered to its clients; and • not be linked to the volume and/or value of transactions executed on behalf of the clients.	shall: • only be based on a thorough assessment ~~research budget set~~ by the investment firm ~~for the purpose of establishing the~~ of its needs for third party research in respect of investment services rendered to its clients; and • ~~not~~ be linked to the quality of the research.~~volume and/or value of transactions executed on behalf of the clients.~~
	The total amount of research charges received in the research payment account may not exceed the research budget. The investment firm must agree with each client 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. The investment firm may only increase the research budget with the client's written agreement. If there is a surplus in the research payment account at the end of a period, the firm should have a process to rebate those funds to the client or to offset it against the research budget and charge calculated for the following period.	~~The total amount of research charges received in the research payment account may not exceed the research budget.~~ The investment firm must inform ~~agree with each~~ its clients ~~the research charge as budgeted by the firm and the frequency with~~ of the methodology under which the ~~specific~~ research charges will be deducted from the resources of the clients over the year. ~~The investment firm may only increase the research budget with the client's written agreement. If there is a surplus in the research payment account at the end of a period, the firm should have a process to rebate those funds to the client or to offset it against the research budget and charge calculated for the following period.~~
	b. As part of establishing a research payment account and agreeing a reasonable charge with their client, the investment firm must set and regularly assess a research budget as an internal administrative measure. The research budget is managed solely by the investment firm and is based on a reasonable assessment of the need for third party research. The allocation of	b. As part of establishing a research payment account ~~and agreeing a reasonable charge with their client~~, the investment firm must set ~~and regularly assess a research budget as an~~ internal administrative procedures ~~measure. The research budget is managed solely by the investment firm and is based on a reasonable assessment of the~~ in order to

the research budget to purchase third party research should be subject to appropriate controls and senior management oversight to ensure it is managed and used in the best interests of the firm's clients. Such controls include a clear audit trail of payments made to research providers and how the amounts paid were determined with reference to the quality criteria referred to in paragraph 7(ii)(d). Investment firms may not use the research budget and research payment account to fund internal research.	assess its needs for third party research. The allocation of the research ~~budget~~ payment account to purchase third party research should be subject to appropriate controls and senior management oversight to ensure it is managed and used in the best interests of the firm's clients. Such controls include a clear audit trail of payments made to research providers and how the amounts paid were determined with reference to the quality criteria referred to in paragraph 7(iii)(d). Investment firms may not use the ~~research budget and~~ research payment account to fund internal research.
c. The investment firm is responsible for operating the research payment account. The investment firm may delegate the administration of the research payment account to a third party, provided that the arrangement facilitates the purchase of third party research and payments to research providers in the name of the investment firm without any undue delay in accordance with the investment firm's instruction.	c. The investment firm is responsible for operating the research payment account. The investment firm may delegate the administration of the research payment account to a third party, provided that the arrangement facilitates the purchase of third party research and payments to research providers in the name of the investment firm without any undue delay in accordance with the investment firm's instruction.
d. The investment firm should regularly assess the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions. Investment firms should be able to demonstrate these elements in a written policy and provide it to their clients. It should also address the extent to which research purchased through the research payment account may benefit clients' portfolios (including, where relevant, by taking into account investment strategies applicable to various types of portfolios) and the	d. The investment firm should regularly assess the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions. Investment firms should be able to demonstrate these elements in a written policy and provide it to their clients. It should also address the extent to which research purchased through the research payment account may benefit clients' portfolios (including, where relevant, by taking into account investment strategies applicable to various types of portfolios) and the

approach the firm will take to allocate such costs as fairly as practicable to the various clients' portfolios.	approach the firm will take to allocate such costs as fairly as practicable to the various clients' portfolios.
e. Where an investment firm makes use of the research payment account, it should provide the following disclosure to its clients: • Ex-ante – In line with Article 24(4)(c) of MiFID II, clients should be informed about the budgeted amount for research and the amount of the expected research charge for each of them. This information is further elaborated in the ESMA technical advice on information on costs and charges. • Ex post – In line with Article 24(4)c of MiFID II clients should receive annual information on the total costs that each of them has incurred for third party research. The investment firm should also be required, upon request by their clients or by competent authorities, to provide a summary of the providers who were paid from this account, the total amount they were paid over a defined period, the goods 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.	e. Where an investment firm makes use of the research payment account, it should provide the following disclosure to its clients: • Ex-ante – In line with Article 24(4)(c) of MiFID II, clients should be informed about the methodology with which the research charges will be deducted from their resources over the year.~~budgeted amount for research and the amount of the expected research charge for each of them~~. ~~This information is further elaborated in the ESMA technical advice on information on costs and charges~~ • Ex post – In line with Article 24(4)c of MiFID II~~ clients should receive~~ annual information on the total costs that each of them has incurred for third party research. The investment firm should also be required, upon request by their clients or by competent authorities, to provide a summary of the providers who were paid from this account, the total amount they were paid over a defined period and the goods 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~~.
8. Firms providing execution services should identify separate charge for these services	8. In order to allow portfolio managers to comply with their best execution

that only reflect the cost of executing the transaction (buying or selling a financial instrument). Any other goods or services rendered should be subject to a separately identifiable charge; the supply of these goods or services should not be influenced by (or be conditional on) levels of payment for execution services. Future ESMA guidelines may also be useful in this area.	requirements, ~~F~~firms providing execution services should clearly disclose to the formers the proportion of their trading fees or commissions which remunerate the execution services ~~identify separate charge for these services that only reflect the cost of executing the transaction (buying or selling a financial instrument)~~. Any other goods or services rendered should be subject to a separately identifiable charge; the supply of these goods or services should not be ~~influenced by (or be~~ conditional on~~)~~ levels of payment for execution services. Future ESMA guidelines may also be useful in this area.
9. The European Commission should also consider clarifying that an investment firm that provides execution and research services, and also carries out underwriting and placing activities, should ensure adequate controls are in place to manage any potential conflicts of interest between these activities and between their different clients receiving those services.	9. The European Commission should also consider clarifying that an investment firm that provides execution and research services, and also carries out underwriting and placing activities, should ensure adequate controls are in place to manage any potential conflicts of interest between these activities and between their different clients receiving those services.