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If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

One Manhattan West
New York, NY 10001
212.735.3000

22 Bishopsgate
London EC2N 4BQ
44.20.7519.7000

FCA Proposes Introducing Bundled Payments Option for Investment Research Services

In July 2023, the UK government published its findings from the Investment Research Review (Review) as part of the UK government's Edinburgh Reforms.[1] The Review made a number of recommendations to encourage research production and quality in the UK, which would in turn help increase activity in UK capital markets.

The UK government committed to implementing these recommendations, one of which was to allow buy-side firms to bundle payments for investment research with payments for execution charges. Bundled payments are currently prohibited under the EU's Markets in Financial Instruments Directive (MiFID) for research and execution services, unless the research relates to issuers with market capitalisations of less than €1 billion in certain circumstances.[2] The Financial Conduct Authority (FCA) also amended its equivalent rules by, among other things, allowing bundled payments for investment research related to issuers that have a market capitalisation of less than £200 million, but the Review now recommends its removal entirely.

On 10 April 2024, the FCA published consultation paper CP24/7 (Consultation), which sets out the FCA's approach for removing the prohibition on bundled payments.

The Consultation will close for responses on 5 June 2024 and the FCA aims to publish any rules or guidance in a policy statement in the first half of 2024, within three weeks after the Consultation closes.

We examine the key proposals of the Consultation below.

Background

Under Article 24 of MiFID, payment for investment research cannot be combined with other charges and must either be:

- made by the investment firm receiving the research from their own resources (P&L model); or
- charged for separately through agreement with the client (Research Payment Account or RPA model).

The purpose of this prohibition was to manage the potential conflicts of interest that could arise if research and execution fees were combined, where it could be possible that lower quality or more expensive trade execution is accepted because of the inclusion of research services that are not separately charged. In addition, the unbundling aimed to improve the accountability and price transparency of costs passed on to customers for research and execution services. These requirements were incorporated into the FCA's Conduct of Business Sourcebook (COBS).

[1] For more information on the Edinburgh Reforms, see our 15 December 2022, article, "The Edinburgh Reforms: Big Bang 2.0 or Thoughtful Change?" For more information on the Investment Research Review, see our 31 July 2023, article "UK Investment Research Review: Reforming MiFID II and Revitalising Investment Research in the UK Public Markets".

[2] Article 24(7)-(9), Markets in Financial Instruments Directive 2014 (Directive 2014/65/EU) and Article 1(4)(c) Directive 2021/338/EU. See also Article 13 of Commission Delegated Directive (EU) 2017/593.

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In practice, very few clients have separately paid for investment research and there has been a significant decline in the amount of investment research produced by analysts in the UK. In response to concerns raised by market participants, in 2021, the EU amended the rules to allow firms to bundle the costs of research and execution related to issuers with market capitalisations of €1 billion or less, so long as the firm complied with certain requirements, such as entering into an agreement with the research provider. In 2022, the FCA followed the EU's approach and relaxed the restriction in the UK to allow bundled payments for investment research relating to issuers with a market capitalisation of less than £200 million, but only in respect of fixed income, currency and commodity instruments and where the research was provided by independent research providers.

Proposals

The Review concluded that the prohibition on bundling payments for investment research and execution charges under MiFID has had an adverse impact on the provision of investment research in the UK. The prohibition is also seen to have had a potential negative impact on UK equity capital markets and UK asset managers' competitiveness by reducing access to global investment research.

Consequently, the Consultation proposes amendments to COBS to allow firms carrying on MiFID business the ability to bundle payments for third-party research and execution services in all circumstances, which will sit as a third option alongside the P&L model and the RPA model.

To align with the approach to bundled payments taken in the US (where the approach permits "soft commissions", where payments to broker-dealers for execution and research are combined), the Consultation also proposes to allow a new "non-monetary benefit" that firms can provide or receive in addition to the permitted inducements for firms dealing with MiFID and insurance-based investment products. This new addition would be applicable to all payment options and will cover short-term trading commentary and advice linked to trade execution.[3]

The Consultation acknowledges that the proposed addition of the bundled payments option and the new acceptable "non-monetary benefit" is not currently mirrored in COBS 18, which applies to Undertaking for Collective Investment in Transferable Securities (UCITS) management companies, UK Alternative Investment Fund Managers (AIFMs) and residual collective investment scheme operators. The FCA plans to consult on the required amendments to COBS 18 later this year.

Firms will only be able to bundle payments if they meet the following requirements.

Bundled Payments Policy

Firms will be required to have a formal policy in place that sets out their approach to bundled payments, ensuring that such policies meet the requirements of the Consumer Duty to the extent the relevant firm provides products or services to retail customers[4], including how the governance, decision-making and controls are maintained and kept separate from those related to trade execution. The policy must also set out the action plan and information to be disclosed to clients if the budgeted amount for third-party research is exceeded or increased (see below).

Agreement With Research Providers

Firms will be required to enter into an agreement with research providers that covers the methodology for calculating and separately identifying the cost of research. This is similar to the existing requirement for an agreement between the firm and the research provider under MiFID to take advantage of the €1 billion-or-less exemption from the prohibition on bundling payments.

Allocation of Payments and Costs

Firms will be required to:

- put in place a structure for the allocation of payments between third-party research firms, to maintain competition between such firms in situations where asset managers wish to separate execution services with the provision of investment research, and to align with the payment allocation structures used in other jurisdictions (such as commission-sharing agreements in the US); and
- develop an approach for the allocation of the costs of research purchased through bundled payments across clients, ensuring that the costs incurred by the client are proportionate to the benefit received.

Operational Procedures

Firms will be required to put in place operational procedures for accounts that are used to purchase research, including procedures for ensuring:

- that reconciliation and reporting is done with the appropriate frequency;
- prompt payments are made to research providers; and
- that the risks arising from any unspent surplus amounts and research provider concentrations are monitored and managed.

[3] See COBS 2.3A 19(5) for a full list of these acceptable "non-monetary benefits".

[4] For more information on the FCA's Consumer Duty, please see the 23 February 2023 Skadden publication "UK Adopts a New Consumer Duty: Key Implications for Financial Services Firms".

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Budget

Firms will be required to have a budget in place, to be reviewed annually, that establishes the amount needed for third-party research based on the expected amounts needed to purchase the research rather than on transaction volume. If the charges to clients exceed the budgeted amount, or the budgeted amount is increased, the firm's policy must set out the action plan and the information that will be disclosed to clients.

Periodic Assessment

Firms must periodically assess the value, quality, use and contribution of purchased third-party research to investment decision making. The price paid for research must also be compared against the price paid by other comparable market participants annually.

Client Disclosure

In connection with the provision of research, firms must disclose to their clients:

- their policy on the use of bundled payments;
- the key features of its approach to bundled payments and how it will meet all the relevant requirements;
- whether bundled payments are combined with another payment option, and if so how this is achieved;
- the research providers that the firm uses the most; and
- the costs incurred.

Conclusion

The intention of the proposals is to increase activity and liquidity in, and to improve the market integrity of, UK equity capital markets by improving the ability for UK asset managers to purchase investment research across multiple jurisdictions. While bundled payments would be permitted, firms would be subject to increased administrative compliance requirements to account, record and disclose the costs of producing investment research.

Increasing activity in UK equity capital markets is a key goal of the UK government and these proposed changes follow existing proposals to reform the UK Listing Rules and change the UK prospectus requirements. Access to affordable investment research supports active equity markets. The current MiFID rules have been criticised for negatively impacting analyst coverage of small and medium-sized issuers, while increasing the costs for asset managers. Whether the proposals will be sufficient to have the desired effect on UK equity markets remains to be seen, but it is hoped they will be a contributing factor alongside other proposed reforms. The UK government has also expressed a desire to improve and enhance the UK asset management sector.

Contacts

Danny Tricot
Partner / London
44.20.7519.7071
danny.tricot@skadden.com

Greg Norman
Partner / London
44.20.7519.7192
greg.norman@skadden.com

Azad Ali
Of Counsel / London
44.20.7519.7034
azad.ali@skadden.com

Adam M. Howard
Counsel / London
44.20.7519.7091
adam.howard@skadden.com

Justin Lau
Associate / London
44.20.7519.7029
justin.lau@skadden.com

Abigail B. Reeves
Associate / London
44.20.7519.7282
abigail.reeves@skadden.com

David Y. Wang
Associate / London
44.20.7519.7149
david.y.wang@skadden.com

William Adams
Trainee Solicitor / London
44.20.7519.7000
william.g.adams@skadden.com