FCA proposes to expand payment optionality rules to fund managers

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On 26 July 2024, in response to the UK Government's Investment Research Review (IRR) on the effectiveness of the investment research market, the FCA published its final rules and guidance to permit the bundling of payments for investment research and trade execution by investment firms. The final rules, which took effect on 1 August 2024, adapt the FCA's policy to evolving markets and better align with the regulatory position in the EU and US. The FCA has now proposed to extend reintroduction of the bundled payment model to managers of pooled funds – i.e., AIFMs and UCITS ManCos.

In this briefing we explore the impact of the new rules, their policy rationale, and the consultation to extend them to fund managers.

Policy background

Partly in response to concerns among EU policymakers that research costs were significantly higher in the EU than the US, the revised Markets in Financial Instruments Directive (MiFID II) introduced a requirement to "unbundle" charges for execution from charges for research. The hope was that these unbundling requirements would better manage conflicts of interest, bring down research costs, drive greater price transparency and facilitate firms' ability to "shop around" for research. Firms were required to purchase investment research from their own resources (P&L model) or implement and use a Research Payment Account for each client (RPA model). In the wake of these new requirements, many firms elected simply to absorb research costs into their own resources rather than put in place the more complex RPA structure. When implementing MiFID II, the FCA decided to apply the rules on bundled research and the use of RPAs to AIFMs and UCITS ManCos, in line with the scope of domestic UK rules on dealing commission which were in place at the time.

Over time, there have been incremental adjustments to the regulation of research. For example, in 2022 the FCA introduced exemptions to the inducement rules for research on SMEs with a market cap under GBP 200 million, FICC research, openly available research, and research provided by research providers who do not provide execution services and are not part of a group that offers execution services. At about the same time, the EU also introduced similar reforms relaxing the research unbundling rules in respect of small and mid-cap issuers (i.e. with a market cap under EUR 1 billion) as part of its "MiFID Quick Fix" response to assist the EU's economic recovery following the COVID-19 pandemic. However, these adjustments have not been sufficient to stem some of the negative effects of the research rules baked into MiFID II.

Although the FCA's analysis suggests that research expenditure (and hence investor costs) declined following the introduction of MiFID II, this decline has not been significant relative to trade execution costs, and was offset by growth in internal research capabilities. Another key concern that may have prompted the

FCA to take action was the suggestion that the MiFID II reforms unintentionally reduced research activity overall, with a negative knock-on effect on liquidity in UK listed stocks[1].

The UK reforms that are now set to be implemented are underpinned by the findings of the Investment Research Review (IRR). The IRR, commissioned by the UK government, assessed (among other things) the impact of unbundling the investment payment rules on the competitiveness of the UK's capital markets. It evaluated the connection between research and companies opting to list in the UK along with the impact which the unbundling rules had on the investment market. The IRR recommended the introduction of additional optionality regarding payment for research in order to permit buyside firms to pay for research on a bundled basis and ensure that UK firms remain able to procure research from elsewhere in the world, in particular the US.

For more detail on the IRR and international challenges, as well as the EU's now-finalised reforms to roll back the MiFID II unbundling rules, see our related client alert on the UK's payment optionality reforms for MiFID investment firms.

Reintroducing the bundled payment model: what do fund managers need to do?

In response to the IRR recommendations and these international challenges, in August 2024 the FCA reintroduced for MiFID investment firms a bundled payment option for third-party research and execution services, which will sit alongside the existing P&L and RPA models already available. Investment firms wishing to rely on the bundled model need to comply with a number of detailed guardrails. While the FCA made a number of changes to the final version of the guardrails with a view to achieving greater proportionality and flexibility, it remains to be seen whether firms will be willing to comply with the necessary operational hurdles in order to move to a bundled model.

The FCA now proposes to extend the bundled payment option to fund managers. These new proposals will allow fund managers to purchase investment research using the new joint payment method already introduced for MiFID investment firms, and are intended to treat managers of pooled vehicles consistently with managers of segregated mandates (consistent with the FCA's application of the MiFID II rules on bundled research and, before that, UK domestic rules on dealing commission). While the application of the rules is intended to be substantially the same, the FCA has made some adjustments to the proposals reflecting the nature of fund management.

Operational requirements for bundled payments

Mirroring the requirements for MiFID investment firms, fund managers wishing to use the bundled payment option will need to comply with a number of new governance and conduct guardrails. These include:

- A **formal policy describing the fund manager's approach to bundled payments** for each fund they manage, including with respect to governance, decision-making and controls, and how these are maintained separately from those applied to trade execution.
- **Putting in place arrangements that stipulate the methodology for how research costs are separately identified.** This requirement is intended to accommodate a broad range of potential

[1] See: https://www.bath.ac.uk/announcements/mifid-ii-unbundling-rules-damaged-research-and-liquidity-in-londons-main-stock-market-new-study/

market practices and arrangements, whether bilateral or multilateral, and whether physically and electronically documented, and ranging from negotiated agreements to standard terms of business. Implementation of this standard may require firms to come to an agreement with their research providers on the methodology for calculating the cost of research.

- For each fund they manage, establishing **a structure for allocating payments** between research providers including those who do and do not offer trade execution.
- **Operational procedures for administering accounts used to purchase research**, including that timely payments are made to research providers. Where a fund manager delegates these operational responsibilities, it remains responsible for ensuring that reconciliation and reporting for such accounts is undertaken with an appropriate frequency and timeliness, and that risks arising from unspent surplus amounts and research provider concentrations are monitored and managed.
- A **budget to establish the amount needed for third party research**. Fund managers will be required to set the budget annually for each fund they manage based on the expected amount of third-party research, which is independent from the volume or value of trade transactions. As fund managers are required to act in the best interests of the fund and its investors, the budget should be set at the level of each fund to avoid one fund subsidising another. If the cost of research increases or exceeds the research budget, fund managers will be required to inform the governing body of the fund (where independent of the manager), assess whether the higher cost would be in the interests of investors, and make sure that (where applicable) the increase in research charges is assessed as part of the assessment of value under COLL or the value assessment under the Consumer Duty. Fund managers will also be required to provide appropriate disclosure in relevant fund documents. For authorised funds, managers will be required to provide appropriate disclosure on the reason for higher research costs for joint payments.
- An **approach to the allocation across clients of the costs** of research purchased through bundled payments. Fund managers will need to allocate the cost of research fairly to the funds they manage taking into consideration of the budget set at the level of each fund.
- **Periodic assessment of the value, quality, use and contribution to investment decision-making** of the research purchased for each fund they manage. The FCA clarifies that an authorised fund manager using joint payments should assess the value and quality of investment research within the wider assessment of value under the COLL rules, and will not be expected to carry out a separate assessment of value for joint payments.
- **Disclosure in fund documents** on the fund manager's use of bundled payments. For authorised funds, the FCA proposes to make relevant adjustments to COLL rules to reflect these disclosure requirements in funds' prospectuses and annual reports. Reflecting the adjustments made for the context of fund management, the FCA will require information about the fund's policies and processes around joint payments to be disclosed in the prospectus, while information on what joint payments have been used for and how much they represent must be disclosed in the annual report.

Other points to note

The FCA considers that the proposed guardrails together with the existing requirements under the Consumer Duty will adequately protect retail investors so that the new payment option can be treated as a significant change rather than a fundamental one. This means that for authorised retail funds, fund managers will be required to treat the take-up of joint payments as a significant change under the relevant COLL rules and guidance. Fund managers are required to inform unitholders of the new payment option at least 60 days before the payment option is adopted. Fund managers are also required to seek FCA

approval for making a significant change to a fund. For Qualified Investor Schemes (QIS), the rules are less prescriptive in relation to making changes to a fund and the FCA does not plan to provide additional guidance to managers of QIS if they choose to take up the joint payment option. Managers of Long-term Asset Funds (LTAFs) who wish to take advantage of proposed joint payments would need to meet the relevant requirements within the existing rules, depending on whether the fund has been made available to retail investors who are not limited protection LTAF investors. For unauthorised funds, the rules do not set requirements for fund managers making changes – however, the FCA would expect managers to act fairly in the interests of investors.

The final rules for MiFID investment firms also confirm that short-term trading commentary and advice linked to trade execution are among the acceptable minor non-monetary benefits for all payment options. The FCA proposes to replicate these changes for funds.

Going forward

With the introduction of the new rules, firms themselves can now determine both whether and when they wish to avail themselves of the new payment option. Firms will need to determine what contractual obligations they are under before starting to use the new payment option, including what information they would need to communicate to clients and whether they would have to obtain client consent – and where there are retail clients involved, what considerations they should have under the Consumer Duty. This consultation, which closes on 16 December 2024, proposes to align the rules applying to AIFMs and other fund managers to the new payment optionality requirements. Final rules are expected during the first half of 2025.

In general, the introduction of rebundling is positive in the sense that it will ensure the UK is aligned with the key US and EU markets. Smaller, more fast-growing firms and new entrants are also likely to benefit from the bundled payment option, avoiding the need to self-fund research or build internal research capabilities under the P&L model or outlay costs to create and operationalise the RPA model. It may not, however, work to reverse the increasing trend of buy-side firms building up and relying upon their own internal research functions.

Despite the potential benefits of rebundling execution and research costs, there is a question as to whether the governance and conduct guardrails now proposed by the FCA for fund managers will prove too operationally onerous to made bundled payments an attractive option. The FCA's cost-benefit analysis in its consultation relating to payment optionality for MiFID investment firms indicated that only a minority of buyside firms would be interested in taking up the proposals with these guardrails in place, and feedback to that consultation indicated that fewer respondents would take up the new option than those that would not. Interestingly, while they are mostly aligned to the EU's rebundling reforms (published in the Official Journal on 14 November 2024), the FCA's rule changes are – unusually – more granular in nature. Given that take-up is one component of the FCA's three-pronged approach to measuring success of the new option, it remains to be seen whether the FCA will further align the guardrails to the EU reforms to preserve the competitiveness of the UK sector.

Contacts

Caitlin McErlane
Partner
+44 20 7919 1894
caitlin.mcerlane
@bakermckenzie.com

Kimberly Everitt
Senior Knowledge Lawyer
+44 20 7919 1048
kimberly.everitt
@bakermckenzie.com