CAPITAL INSTITUTIONAL SERVICES, INC.

February 2015

Update on ESMA MiFID II Dealing Commission Proposal

Introduction

The European Securities and Markets Authority (ESMA), whose members are the financial markets regulators in each of the 28 European Union member states, released revised technical advice on the implementation of Markets in Financial Instruments Directive (MiFID II). The revised MiFID II rules have retreated from a complete ban on using commissions to pay for research, as was proposed this past summer.

ESMA's original proposal stated that using commissions to pay for research qualified as an "inducement" which could create conflicts of interest. A large majority of respondents disagreed and were concerned that the inability to pay for research with commissions could lead to numerous unintended consequences such as a significant increase in costs for active managers, disadvantages for smaller managers, and raised barriers of entry for new managers.

ESMA revised MiFID II proposal has retreated from a complete ban on using commissions to pay for research. Although this amendment may come as a relief to many investment managers, the revised proposal has included significant changes that will impose stringent guidelines on how research must be paid for using client commissions going forward.

Proposal

ESMA stated in its revised proposal that the provision of research by third-parties to investment managers would not be considered an inducement if:

- The research is paid directly by the investment manager out of their own funds
- The research payments are only made from a fund specifically used to pay for third-party research
- The research is paid out of a research payment account controlled by the investment firm, and overseen by senior management, if the following conditions are met:
    - Research payments can only be based on the research budget set by the investment firm establishing the need for third-party research. The research budget and any increases in the research budget must be approved with respect to amount and frequency by the investment manager's clients.
    - Research payments cannot be linked to volume or value of transactions.
    - The total amount of research received cannot exceed the research budget.
    - Any remaining balances in the research budget must be returned to the clients or used to offset against the budget for the following period.
- The research is regularly assessed for quality and the ability to help in the investment decision making process.

- The following disclosures are made available to clients if a firm makes use of a research payment account:
  - Ex-ante – disclosure about the amount budgeted for research and the amount of the expected charge for each item.
  - Ex-post – clients should receive information on the total costs incurred for third-party research. The investment manager should also be prepared to provide the following information is requested by clients or authorities, a summary of the providers who were paid from the research account, the amount they were paid and the goods and services received, and how the total amount spent from the account compares to the research budget set. Any rebate or carry-over should be disclosed.

CSAs

With the new proposal, the use of commission sharing arrangements (CSAs) will become an integral part of paying for research with commissions. Use of a CSA would ensure that execution and research are unbundled and that a research budget would not be influenced by trading volumes.

Executing brokers who offer research services will need to price execution and the value of research services separately to enable portfolio managers to meet the new restrictions on inducements. This would ensure transparency in the market place and help managers adhere to compliance with the new requirements.

Items to Consider

MiFID II only applies to investment firms managing separate accounts. Therefore, the proposals put forth by ESMA only apply to these firms. ESMA is proposing to the European Commission that the new rules regarding research payments fall under UCITS (managed funds) and AIFMD (hedge fund) as well.

The new proposal does not address the issue of VAT. Currently, bundled research is not subject to VAT. Unbundling research and execution could lead to research being imposed with VAT which would reduce the amount of payment received by the research providers.

Next Steps

The ESMA release will be open for comment until March 2, 2015. The final technical advice will be sent to the European Commission for endorsement by January 2016 with the final rules going into effect January 3, 2017.