

# MiFID II Inducements

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### Quick Read

1. MiFID II introduces changes to the previous inducements regime which may have significant impact on portfolio managers and independent investment advisors, in particular.
2. The rules are designed to benefit the client and to create a significant level of transparency.
3. The rules apply to MiFID II investment firms, to credit institutions when performing MiFID II investment services or activities and to UCITS ManCos and AIFMs who have extended their authorisations to include portfolio management and, potentially, non-core services but only in respect of those extended services.
4. The general rule is that inducements received by a firm cannot be retained by it unless they are designed to enhance the quality of the service to the client and do not impair compliance with the firm's overriding duty to act honestly, fairly and professionally in accordance with the best interests of the client.
5. Portfolio managers and investment advisers who advise on an independent basis are however prohibited from accepting and retaining inducements. They can receive, but must then pay over to client.
6. Certain minor non-monetary benefits can be retained, where disclosed to the client.
7. Research will not constitute an inducement caught by the prohibition where it is paid for by the firm itself out of its own resources or out of a research payment account ("**RPA**") funded by a specific research charge to the client.
8. Significant compliance obligations apply to the operation of a RPA including rules on what can be paid for, agreeing a research budget with the client, reviewing and assessing the purchased research and periodic disclosure to clients and more.
9. The rules also apply to the firms who provide research and execution services, as they will be required to unbundle the two elements and charge for them separately.
10. The new rules apply from January 3, 2018 and are likely to require firms to undertake significant preparatory work prior to that date.

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## Inducements under MiFID II

### Introduction

MiFID II brings with it many challenges, one of which is the new set of requirements dealing with inducements which aims to strengthen the protection of investors and increase clarity to clients as to the quality of services they receive. The core requirements underpinning the MiFID II inducements regime remains the same as they were under MiFID I, namely:

- the obligation to act honestly, fairly and professionally in accordance with the best interests of the clients;
- the conflicts of interest provisions; and
- the disclosure obligations.

However, the MiFID II regime goes much further than that under MiFID I as:

- it requires firms, where applicable, to inform the client on mechanisms for transferring to the client the fee, commission or monetary or non-monetary benefit received in relation to the provision of the investment or ancillary service;
- it prohibits those firms which are providing clients with either investment advice on an independent basis or with portfolio management services from accepting and retaining fees, commissions, or any monetary or non-monetary benefits from third parties in relation to the provision of the service to clients (other than certain minor non-monetary benefits);
- it introduces specific rules relating to the payment of and for research; and
- it requires additional and specific disclosures, imposes record keeping obligations and requires implementation and application of associated policies and procedures.

These new rules are likely to have significant impact on the asset management industry, in particular.

### Where can I find the rules?

The inducements rules are found in Article 23(1), in Article 24(1), (7), (8) and (9) and in Article 27(2) of MiFID II. Article 23(1) is set within the *Operating conditions for investment firms* provisions of MiFID II with particular focus on conflicts of interest, whereas each of Article 24 and Article 27 is set within the *Investor protection* provisions.

Detailed elaborations of the requirements are contained within the MiFID II Commission Delegated Directive 2017/593 (the “**Delegated Directive**”), Chapter IV of which focuses on inducements with successive Articles dealing with inducements generally [Article 11], with inducements in respect of investment advice on an independent basis or portfolio management services [Article 12], and with inducements in relation to research [Article 13].

Related provisions are found in the Commission Delegated Regulation (EU) 2017/565 supplementing the MiFID II Directive (the “**Delegated Regulation**”) where inducements are included in the list of items to be taken into account for the purposes of identifying types of conflicts of interest [*Article 33, Conflicts of interest potentially detrimental to a client*] and where the information to be disclosed to clients concerning fees and monetary and non-monetary benefits connected with execution is addressed [*Article 66, Execution Policy*].

In addition, the European Securities and Markets Authority (“**ESMA**”) has issued a *Questions and Answers document On MiFID II and MiFIR investor protection topics* which provides detailed answers to inducements related questions, principally relating to research matters (the “**ESMA Q&A**”). The inducements related Recitals to the Delegated Directive – Recitals (21) to (30) - are also very important in providing context and clarity on the inducement rules and it is notable that they are referred to frequently by ESMA in its Q&A.

### **Who do the rules apply to?**

The inducements rules apply to:

- (i) investment firms (as defined in Article 4(1)(1) of MiFID II);
- (ii) credit institutions when providing investment services and activities (within the meaning of Article 4(1)(2) of MiFID II);
- (iii) investment firms and credit institutions when selling or advising clients in relation to structured deposits; and
- (iv) UCITS ManCos and external AIFMs (as defined in Article 5(1)(a) of the AIFMD) when providing the investment services of individual portfolio management or non-core services (within the meaning of Article 6(3)(a) and (b) of the UCITS Directive and Article 6(4)(a) and (b) of the AIFMD).

(each a “**firm**”)

### **Timing**

The inducements rules apply from January 3, 2018.

However, affected firms will need to spend considerable time in advance of that date in preparing for the new regime’s implementation, including the establishment of relevant policies and procedures, the establishment of research payment accounts (“**RPAs**”) – to include budgeting, charging arrangements, client disclosures, etc. – as well as mechanisms for payments to clients.

Certain firms will need to determine separate charging arrangements for, on the one hand, execution services and, on the other, research, and there will be more to do.

## General Inducements Rules

### General Principles

When providing investment services or, where appropriate, ancillary services to clients, firms must act honestly, fairly and professionally in accordance with the best interests of their clients and must comply, in particular, with the principles set out in Article 24 [*General principles and information*] and in Article 25 *Assessment of suitability and appropriateness and reporting to clients*] of MiFID II.

This is a core requirement of MiFID II, but not a new one as the same obligation was found within MiFID I. Again, similar to MiFID I, MiFID II makes it clear at Article 24(9) that firms will not be regarded fulfilling their obligations under Article 23 (i.e. obligation to identify and prevent or manage conflicts) or their obligations under Article 24(1) (i.e. its obligation to act honestly, fairly and professionally etc.) where they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit in connection with the provision of an investment service or an ancillary service, to or by any party except the client or a person on behalf of the client, other than where the payment or benefit:

- (i) is designed to enhance the quality of the relevant service to the client; and
- (ii) does not impair compliance with the firm's duty to act honestly, fairly and professionally in accordance with the best interests of its clients.

### Clear disclosure to the Client required

The existence, nature and amount of the payment or benefit or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service.

Where applicable, the firm must also inform the client on mechanisms for transferring to the client the fee, commission, monetary or nonmonetary benefit received in relation to the provision of the investment or ancillary service.

### Payments or benefits which do not offend the rule

Firms will, however, be able to pay or be paid a payment or benefit which enables or is necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which by its nature cannot give rise to conflicts with the investment firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients without failing foul of the general principle.

### Which fees, commissions or benefits are designed to enhance?

A fee, commission or non-monetary benefit shall be considered to be designed to enhance the quality of the relevant service to the client if all of the following conditions are met:

- (i) it is justified by the provision of an additional or higher level service to the relevant client, proportional to the level of inducements received, such as:
  - (a) the provision of non-independent investment advice on and access to a wide range of suitable financial instruments including an appropriate number of instruments from third party product providers having no close links with the investment firm;
  - (b) the provision of non-independent investment advice combined with either: an offer to the client, at least on an annual basis, to assess the continuing suitability of the financial instruments in which the client has invested; or with another on-going service that is likely to be of value to the client such as advice about the suggested optimal asset allocation of the client; or
  - (c) the provision of access, at a competitive price, to a wide range of financial instruments that are likely to meet the needs of the client, including an appropriate number of instruments from third party product providers having no close links with the investment firm, together with either the provision of added-value tools, such as objective information tools helping the relevant client to take investment decisions or enabling the relevant client to monitor, model and adjust the range of financial instruments in which they have invested, or providing periodic reports of the performance and costs and charges associated with the financial instruments
- (ii) it does not directly benefit the recipient firm, its shareholders or employees without tangible benefit to the relevant client;
- (iii) it is justified by the provision of an on-going benefit to the relevant client in relation to an on-going inducement.

**Note:** A fee, commission, or non-monetary benefit will not be considered acceptable if the provision of relevant services to the client is biased or distorted as a result of the fee, commission or non-monetary benefit.

In addition, firms must fulfil the above requirements on an ongoing basis as long as they continue to pay or receive the fee, commission or non-monetary benefit.

#### **Evidence to be maintained by firms**

Firms must hold evidence that any fees, commissions or non-monetary benefits paid or received by the firm are designed to enhance the quality of the relevant service to the client by keeping an internal list of all fees, commissions and non-monetary benefits received by the investment firm from a third party in relation to the provision of investment or ancillary services. They must also record how the fees, commissions and non-monetary benefits paid or received by the investment firm, or that it intends to use, enhance the quality of the services provided to the relevant clients and the steps taken in order not to impair the firm's duty to act honestly, fairly and professionally in accordance with the best interests of the client.

**Required disclosures to clients**

In relation to any payment or benefit received from or paid to third parties, firms must disclose to the client the following information:

- (i) prior to the provision of the relevant investment or ancillary service, the firm must disclose to the client information on the payment or benefit concerned. Minor non-monetary benefits may be described in a generic way. Other non-monetary benefits received or paid by the investment firm in connection with the investment service provided to a client shall be priced and disclosed separately;
- (ii) where a firm was unable to ascertain on an ex-ante basis the amount of any payment or benefit to be received or paid, and instead disclosed to the client the method of calculating that amount, the firm must also provide its clients with information of the exact amount of the payment or benefit received or paid on an ex-post basis; and
- (iii) at least once a year, as long as (on-going) inducements are received by the firm in relation to the investment services provided to the relevant clients, the firm must inform its clients on an individual basis about the actual amount of payments or benefits received or paid. Again, minor non-monetary benefits may be described in a generic way.



## Independent Advice and Portfolio Management

Firms providing investment advice on an independent basis and those providing portfolio management services are subject to a prohibition or ban on accepting and retaining inducements from third parties in relation to the services provided to the client.

Exceptions apply in respect of certain minor non-monetary benefits and, as explained in the next section of this paper, research is not treated as an inducement where paid for by the firm itself or out of a research payment account meeting a variety of conditions.

### General Prohibition

MiFID II provides that:

- (i) where a firm informs the client that investment advice is provided on an independent basis [Article 24(7)]; or
- (ii) where a firm is providing portfolio management services;

the firm shall not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the services to clients. Excluded from the prohibition are minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the firm's duty to act in the best interest of the client. Such minor non-monetary benefits must be clearly disclosed.

### Return to Client

The prohibition above is on accepting and retaining. Where firms receive any such fee, commission or monetary or non-monetary benefit, they must return it in full to the client as soon as reasonably possible after its receipt.

Firms are required to set up and implement a policy to ensure that any fees, commissions or any monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of independent investment advice and portfolio management are allocated and transferred to each individual client.

### Clients must be informed

Firms must inform clients about the fees, commissions or any monetary benefits transferred to them, such as through the periodic reporting statements provided to the client.

### Minor non-monetary benefits

The following benefits qualify as acceptable minor non-monetary benefits only if they are:

- (i) information or documentation relating to a financial instrument or an investment service, is generic in nature or personalised to reflect the circumstances of an individual client;
- (ii) written material from a third party that is commissioned and paid for by an corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any firms wishing to receive it or to the general public;
- (iii) participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service;
- (iv) hospitality of a reasonable *de minimis* value, such as food and drink during a business meeting or a conference, seminar or other training events mentioned under point (iii); and
- (v) other minor non-monetary benefits which the relevant competent authority deems capable of enhancing the quality of service provided to a client and, having regard to the total level of benefits provided by one entity or group of entities, are of a scale and nature that are unlikely to impair compliance with a firm's duty to act in the best interest of the client.

Acceptable minor non-monetary benefits must be reasonable and proportionate and of such a scale that they are unlikely to influence the firm's behaviour in any way that is detrimental to the interests of the relevant client.

**Note:** additional guidance on what may or may not be acceptable minor non-monetary benefits is found in Recitals (29) and (30) of the Delegated Directive and also within the ESMA Q&A.

#### **Disclose to client before service provided**

Disclosure of minor non-monetary benefits must be made prior to the provision of the relevant investment or ancillary services to clients and can be described in a generic way.

## Research and RPAs

Probably the most significant development in this area for portfolio managers and independent investment advisers is the new set of provisions relating to research and, in particular, to the provisions relating to research payment accounts (“**RPA**”).

Remember that such firms are prohibited from accepting and retaining inducements other than certain minor non-monetary benefits which must meet certain conditions and be disclosed. The Delegated Directive provides at Article 13 that the provision of research by third parties to firms providing portfolio management or other investment or ancillary services to clients will not be regarded as an inducement if it is received in return for any of the following:

- (i) direct payments by the firm out of its own resources; or
- (ii) payments from a separate RPA controlled by the firm, provided certain conditions relating to the operation of the RPA are met.

### Research Payment Account

The conditions which need to be met for the operation of the RPA are as follows:

- (i) the RPA must be funded by a specific research charge to the client;
- (ii) as part of establishing a RPA and agreeing the research charge with their clients, firms must set and regularly assess a research budget as an internal administrative measure;
- (iii) the firm is held responsible for the RPA;
- (iv) the firm must regularly assesses the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions.

Where a firm makes use of the RPA, it must provide the following information to clients:

- (i) before the provision of an investment service to clients, information about the budgeted amount for research and the amount of the estimated research charge for the client.
- (ii) annual information on the total costs that the client has incurred for third party research.

### Research Charge

The specific research charge must only be based on a research budget set by the firm for the purpose of establishing the need for third party research in respect of investment services rendered to its clients.

It must not be linked to the volume and/or value of transactions executed on behalf of the clients.

Every operational arrangement for the collection of the client research charge, where it is not collected separately but alongside a transaction commission, must indicate a separately identifiable research charge and fully comply with the RPA qualifying conditions and the conditions relating to the provision of information to clients.

**Note:** The total amount of research charges received may not exceed the research budget.

### **Research budget must be agreed with client**

A research budget needs to be agreed with clients, either in the investment management agreement or the firm's general terms of business. That must also include the frequency with which the specific research charge will be deducted from the resources of the client over the year. Increases in the research budget must only take place after the provision of clear information to clients about such intended increases and if there is a surplus in the research payment account at the end of a period, the firm must 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.

Budgeting for research should take place at the outset of the research procurement process in order to determine the level of the research charge in the best interest of clients. Budgets need to be regularly reviewed and the research budget is an ex-ante estimate of forecast expenditure for research costs that can be charged to portfolios with similar strategies under management.

The research budget must be managed solely by the firm and must be based on a reasonable assessment of the need for third party research. In addition, the allocation of the research budget to purchase third party research must 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. The required 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 above. Note that firms must not use the research budget and research payment account to fund internal research.

In its Q&A, ESMA states a budget can be set for a group of client portfolios or accounts where the firm has established a similar need for third party research in respect of the investment services rendered to its clients, for example, if client portfolios have sufficiently similar mandates and investment objectives such that investment decisions relating to those portfolios are informed by the same research inputs. However, the firm is still required to identify a specific research charge for individual clients to fund the RPA, even where a budget is set for several portfolios. A firm will therefore need to have a transparent method for making a fair allocation of costs in such cases which may involve the firm *pro-rating* the cost of the research budget across all client accounts benefitting from it based, for example, on the value of each client's portfolio, to establish a specific charge for individual clients.

A firm may also choose to set a firm-level research budget to help it control overall costs, but this does not replace the need to set budgets for discrete groups of client portfolios and accounts as described above.

## **Outsourcing administration of RPA**

A firm can delegate the administration of the RPA 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 firm without any undue delay in accordance with the firm's instruction.

When administration of the RPA is outsourced, the firm must maintain legal control over RPA funds until such time as it decides to make a payment to a research provider. The firm must be satisfied that, through the outsourced agreement, it continues to retain full discretion and control over the use of the account. Importantly, the money should be ring-fenced and clearly separated from other funds of the RPA Administrator, such that they remain legally owed to the investment firm and the third party provider must not have a right of set-off over the money or be entitled to use it as collateral or otherwise for their own benefit.

## **Requirement to provide information on RPA to clients and regulators**

Where a firm operates a RPA, the firm must upon request by clients or by competent authorities, provide a summary of the providers paid from this account, the total amount they were paid over a defined period, the benefits and services received by the 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.

## **Who owns the funds?**

Once the research charge is deducted from a client, the funds belong to the firm. However, the research fund should be managed in an RPA controlled by the firm and it should be used specifically for purchasing external research to benefit the client. ESMA is of the opinion – see the ESMA Q&A - that it is important that the firm makes its best efforts to align as much as possible the timing of the charges paid by the client to the firm, and the expenditure on research paid from the RPA by the firm to the research provider.

## **Free Research**

Noting that firms need to have policies and systems in place to assess the nature of any service, benefit or material paid or provided by any third party to determine whether they can provide or accept it, it is not acceptable for firms to receive research for free where no assessment has been made under the inducements rules or there is no payment arrangement in place that complies with MiFID II Rules.

A firm providing independent investment advice or portfolio management services can only receive research in relation to those activities by complying with the Delegated Directive. In that context, firms should not accept research for 'free'.

**Providers of research to separately charge for execution**

A firm which provides execution services must identify separate charges for these services that only reflect the cost of executing the transaction. The provision of unsolicited (or 'free') research would not meet the obligation to price services separately, and firms should have systems and controls in place to enable them to cease providing unsolicited research.

**Research from Third Country Providers or from Group Companies**

Firms should therefore treat research from a third country provider in the same way as any other third party benefits.

Similarly, the rules apply irrespective of the relationship between the provider of fees, commissions or monetary or non-monetary benefits and the firm receiving them, (i.e. irrespective of being part of the same group or not).

**Research Policy**

Firms must have a written research policy and provide it to their clients. The policy must 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 fairly to the various clients' portfolios.

The criteria against which the quality of the research material purchased should also be set out in the policy which also needs to explain how the research inputs can contribute to better investment decisions and how the related costs can be allocated in a manner that is fair to the various clients' portfolios.

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