

The FCA's Disapplication of MifID II Research Rules: Practical Considerations

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Executive Summary

- The FCA has outlined their changes to the MiFID II Research Rules.
- They have made certain exemptions to the rules concerning investment research, whilst they have rejected some proposals put forward in their consultation.
- These changes have left investors unclear as to how to implement them practically.
- The lack of clarity coupled with minimal buy-side engagement with brokers has hindered investment firms' understanding of these new rules.
- This report outlines the factors that investment firms should consider when navigating these rules and how to update their relationships with brokers.

Introduction

This report describes the key changes to the MiFID II research rules and provides advice on how investment firms should respond. There remain quite a few elements that investment firms need to consider to ensure that they get the most benefit out of these changes.

Summary of changes

The Financial Conduct Authority (FCA) on 30 November, 2021 published their final policy position on MiFID II research rules,¹ outlining proposed changes to the existing regime. These new rules took effect on 1 March 2022 with the primary intent of increasing the availability of research on small and medium enterprises (SMEs) as stated in the FCA's Policy Statement.

With this aim, the FCA has confirmed certain exemptions to the MiFID II rules concerning explicit investor payment to brokerages for their research and corporate access. From now on research and access for SMEs with a market capitalisation of less than £200 million will be exempt. In addition, third-party research on FICC also is exempt, as is research provided by research providers who do not provide execution services and are not part of a group that includes a firm offering execution services. However, following the FCA's proposals, openly available written research remains out of scope of MiFID II.

While such moves are generally welcome, a number of proposals have been rejected by the FCA.² For example, the regulator decided not to increase the SME exemption to £2 billion/€1 billion based on an analysis of where the issue of a lack of research in the market in the UK is most acute. Raising this would have been in line with MiFID II's "Quick Fix" regulations.³ They also did not expand FICC exemptions to include macroeconomic research.

This results in dual operating models in which firms must consider what fixed income research is exempt and that for which firms must still be pay. Extending FICC exemptions to include FICC corporate access, as well as commenting on the implications of the SEC no-action letters, were also both rejected.⁴

Market observations

Investors remain unsure about the practical implications of these rules. Most firms are unaffected by the £200 million limit. There will very likely be no change from an independent research provider perspective given that it is their business model to charge. Brokers' pricing structures are limited which will also mean there will be little change. Multijurisdictional businesses may find it difficult to discern if they are in compliance with Europe's implementation of MiFID II, which may differ from the FCA's (especially now in terms of research).

¹ [PS21/20: Changes to UK MiFID's conduct and organisation requirements \(fca.org.uk\)](https://www.fca.org.uk/publications/ps21/20-changes-to-uk-mifid-ii-conduct-and-organisation-requirements)

² [PS21/20: Changes to UK MiFID's conduct and organisation requirements \(fca.org.uk\)](https://www.fca.org.uk/publications/ps21/20-changes-to-uk-mifid-ii-conduct-and-organisation-requirements)

³ https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L._2021.068.01.0014.01.ENG&toc=OJ%3AL%3A2021%3A068%3ATOC

⁴ [PS21/20: Changes to UK MiFID's conduct and organisation requirements \(fca.org.uk\)](https://www.fca.org.uk/publications/ps21/20-changes-to-uk-mifid-ii-conduct-and-organisation-requirements)

Practical considerations for firms

We recommend that firms discuss with their research providers how much FICC research would be considered ‘free’ and a Minor Non-Monetary Benefit (MNMB). A MNMB is described in Article 12.3 of the EU Directive 2017/593 as benefits that are “reasonable and proportionate and of such a scale that they are unlikely to influence the investment firm’s behaviour in any way that is detrimental to the interests of the relevant client”.⁵ Currently, the majority of the costs are macro-economic research and other items must be paid for regardless, so the cost savings are minimal in most cases.

At this point, few firms wish to implement dual operating models for a limited cost saving as doing so would entail extra resources, and firms would not be breaking any rules if they maintained the status quo. In cases where brokers are unwilling to clearly distinguish their Macro research from FICC, the added time required by investors to classify which material is exempt as well as the risk of inadvertent non-compliance render the implementation of the new rules impractical.

To date some brokers have altered their financial models and fees, while others have not. Although discussions are still in their early stages, we recommend determining your brokers’ respective approaches and negotiating terms with them.

Each year, research agreements tend to roll over, and firms must decide what to do for the following year while considering jurisdictional implications. Firms should keep in mind the notice periods that apply when these research

agreements change or terminate. Brokers may be open to updating terms prior to official renewal dates so it is recommended to proactively engage with your brokers on this matter.

Before changing research agreements, Individually Managed Accounts (IMAs) with UK entities must consider any changes that they may need to make. The way MNMBs are described in these agreements must be considered, as this will almost certainly need to be updated. Assertions of compliance with MiFID II in IMAs must also be considered as they may specify compliance with the UK implementation of the Directive 2017/593/EU as opposed to general, European-level provisions, which may avoid further updates.

Finally, consideration of the Senior Managers and the Certification Regime (SMCR) is important. It would be prudent to identify the senior manager in charge of investment research and ensuring that they have received the necessary Management Information. Furthermore, the individual who will make future decisions regarding FICC research must be identified. This is to ensure that everything is documented in order to demonstrate appropriate governance and reasonable steps.

ELFA believes that firms must be vigilant in examining the practical changes that will result from the FCA’s disapplication of the MiFID II research rules. Because these changes are relatively new, the landscape may change, and firms must be aware of these practical changes in order to navigate their relationships with brokers effectively.

⁵ <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32017L0593>

About ELFA:

ELFA is a professional trade association comprised of European leveraged finance investors from over 60 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit the ELFA’s website: www.elfainvestors.com.