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# Research Unbundling — FCA Finds Rules Working Well

***The FCA has published the findings from its review into firms' implementation of the MiFID II research unbundling rules.***

**Key Points:**

- Overall, the FCA found that the rules have produced "positive changes" and have had the intended effect of improving scrutiny of research costs and lowering costs for investors.
- However, the FCA acknowledges that valuation and pricing models are still evolving, and says it plans to carry out further work in this area in 2020 or 2021.

The FCA has published a new webpage setting out the findings from its review into how firms have implemented the MiFID II rules on research unbundling. Overall, the FCA found that the new rules, which require asset managers to pay for research separately from other services, have improved asset managers' accountability over costs. The FCA also found that firms have improved their scrutiny of both research and execution costs, including when firms have chosen to charge research costs to clients. According to the FCA, this resulted in investors in UK-managed equity portfolios across a sample of firms saving around £70 million in the first six months of 2018. The FCA considers that the new rules have moved the market towards the intended outcome, but that research valuation and pricing are still evolving.

## Key Findings From the FCA's Review

The FCA's review took place between July 2018 and March 2019, and included a survey of 40 buy-side firms, 10 firm visits across the buy-side and sell-side, meetings with five independent research providers, and interactions with corporate issuers through trade associations.

Set out below are some of the FCA's key findings. The FCA acknowledges that market changes are still developing, in particular in relation to pricing, and says it intends to carry out further work in this area in 12 to 24 months' time to assess firms' ongoing compliance with the rules.

### How are firms paying for research?

The FCA found that most asset managers have chosen to pay for research from their own resources, rather than using their clients' funds. Only a few firms chose to use research payment accounts, which is

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unsurprising given the prescriptive requirements concerning the operation of such accounts. However, the FCA saw comparable levels of price scrutiny regardless of how asset managers chose to pay for research.

According to the FCA, firms have reduced research expenditure across the board, with research budgets having fallen by around 20% to 30% on average. Despite this, most asset managers said they are still getting the research they need. The FCA deduces, therefore, that most savings must reflect greater competition and market efficiencies, including better cost discipline amongst asset managers.

However, the FCA did find a wide level of variation in how firms value research, with a “clear gap” between the best and worst practices. The FCA indicates that better valuation models included elements such as internal rate cards with ranges of potential payments based on clear quality criteria, internal pricing tiers based on providers’ service levels and quality, and ongoing assessments of the quality and cost of research.

The FCA reminds firms that assessing quality and value is a judgment call. As such, asset managers need to be able to show that their approach to making this judgment is rational and consistent, but do not need to justify every minor variation in pricing. The FCA acknowledges that valuation models are still evolving, and states that it expects firms to continue developing approaches that ensure the way they buy their research is consistent with their duty to act in the best interests of their clients or funds.

### What is the impact on order routing?

The FCA states that it found no evidence of asset managers making hidden equity research payments through inflated commissions for trade executions, as execution-only commission rates agreed between asset managers and brokers were largely the same or lower than pre-MiFID II rates. The FCA also found that asset managers are using brokers for both research and execution less frequently, and some have been making use of lower-cost execution channels.

### What is the impact on research quality and coverage?

The FCA found that most asset managers are still receiving all the research they need, and research coverage of SMEs listed in the UK has “not…[seen] a loss of coverage across the market”. While corporate issuers reported little change in research coverage, they did relate that they had concerns that research coverage or quality could deteriorate over time.

However, this feedback sits against anecdotal evidence that some sectors are not covered as widely by research as they were prior to 2018. Consequently, the FCA will continue to monitor SME coverage by periodically assessing the number of analyst forecasts reported on UK-listed SMEs.

### What is the impact on sell-side research pricing?

The FCA reports that it found a wide range of pricing models, with some firms using tiered price brackets, others offering “pay as you go” pricing, and others pricing per interaction or product. The FCA reminds sell-side firms of their obligation to price research separately from execution services, in response to the feedback from certain asset managers that they found some sell-side firms reluctant to set prices.

Independent research providers suggested that levels of pricing by sell-side firms were potentially too low. They highlighted that this pricing discrepancy, coupled with the fact that many buy-side firms were taking an overly cautious approach to the rules and so were not making use of free trial periods or accepting marketing materials, has had negative effects on competition in the research market.

Interestingly, the FCA states that low "entry level" pricing for research accompanied by higher fees for more exclusive interactions could be a reasonable pricing strategy overall. More generally, the FCA takes the view that pricing is still evolving, and so it expects to review how sell-side pricing models are developing in the further work it plans to carry out in this area in 12 to 24 months' time. This is noteworthy given that in a speech earlier this year, FCA Chief Executive Andrew Bailey suggested that the FCA was scrutinising low pricing models, with the concern that some research was being priced so low that it might amount to an inducement. Evidently the FCA's work has not unearthed significant enough concerns for it to want to raise this subject further. This is a difficult balance for the regulator, as lower pricing is good for ultimate investors, yet choice and quality could be reduced if competition is restricted.

### Grey areas

The FCA notes that uncertainty amongst firms remains as to what benefits other than research they can accept from third parties in compliance with the inducements rules, in particular in terms of what can constitute a minor non-monetary benefit. This is unsurprising given the complexity of the rules, as explained in this May 2018 *Client Alert* on the regime.

The FCA highlights that some asset managers have taken an overly strict approach to marketing materials and free trials. The FCA reminds firms of its carve-out for research trial periods and issuer-sponsored research and encourages firms to make use of these, particularly given the impact of over-cautiousness on independent research providers (as explained above). Further, the FCA explains that, generally, trade association events can be treated outside the inducements framework.

The FCA also clarifies that brokers are permitted to contribute to consensus forecasts without this constituting an inducement. However, if an asset manager wants to speak directly to a broker's analyst who provided a forecast or receive an underlying research report from them, then this could constitute an inducement.

In relation to corporate access, the FCA found that prices vary significantly, which indicates that some of these services may be under-charged and could therefore constitute an inducement. However, the FCA welcomes the fact that more corporate access meetings tend to be arranged without broker intermediation, and issuers reported that the quality of corporate access engagement has improved.

## Other Developments

Meanwhile, at European level, in July 2019 ESMA published a call for evidence on the inducements disclosure requirements under MiFID II. This forms part of a planned review of these provisions, and will feed into work by the European Commission, which could ultimately lead to amendments to the rules.

The call for evidence requests feedback from firms and other interested stakeholders in relation to their experience of the rules and the issues that have arisen, in particular whether firms have seen divergent approaches across different Member States. No doubt the FCA will take any findings from this process into account in its future work.

The FCA notes that it also plans to consider the findings from a forthcoming European Commission study on the impact of MiFID II on SME and fixed income research.

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