Commission unbundling: a new fiduciary responsibility for asset owners. Are you ready???

On April 7, 2016 the European Union released the final version of its new Directive governing the ways that investment managers can purchase research with their client's commission dollars. As Zeno predicted a year ago (see, our article titled, *"'The $250 Econ 101 Textbook' and other Soft-dollar concerns for asset owners,"* which is available on Zeno's website under "Research & Articles"), the Directive imposes stringent new guidelines that managers must adhere to if they want to use client funds to pay for research. This dramatically changes the traditional procedures utilized by managers to purchase research, and in doing so, creates a new fiduciary obligation for asset owners!

While the effective date of these new regulations has been pushed back to January 2018, managers will need to begin approaching their clients sometime in 2017 (in order to have their research budgets compliant by January 2018). The article below is intended to both: alert asset owners of this fast-approaching new fiduciary responsibility, and offer guidance on how to structure new oversight programs that prudently discharge those responsibilities.

Background

Since the 1970s, asset managers have been permitted to purchase research with their client's commission dollars. This practice is commonly termed, "soft-dollars." By bundling the research fee into the commission rate already being paid to a broker (for executing a trade), the manager does not have to pay explicit hard dollars for the research. While this certainly facilitates the acquisition of research, it has also raised concerns that managers may use client commissions to purchase unnecessary research (since the manager is using their clients' money, not its own). For a more complete discussion of soft-dollars and its attendant pros and cons, click here, to read, "*The $250 Econ 101 Textbook' and other Soft-dollar concerns for asset owner."*

Indeed, for the past several years the UK and European Union ("EU") have been concerned about the potential conflicts attendant to the use of soft-dollars; and actively considering whether these soft-dollar trades should be banned. In June 2014, the UK's financial regulatory agency, the Financial Conduct Authority ("FCA") released its final policy statement regarding soft-dollar arrangements.[1] The statement was the culmination of numerous studies, reviews and reports conducted by the FCA (and its predecessor FSA) since 2003, regarding soft-dollar practices within the asset management and brokerage communities.

In its 2014 statement, the FCA criticized the asset management community for inadequate compliance policies and standards of control regarding the conflicts of interest inherent in soft-dollar arrangements. The FCA also reiterated an earlier announcement (made in 2013), that it felt, "*[t]he system is not working as intended. Wider reform is now required to address these flaws that cannot simply be addressed by incremental improvements to the existing rules."* Perhaps more importantly, the FCA expressed concerns that the inherent conflicts associated with manager use of soft-dollars might never be addressed absent regulatory action.

Concurrent with the FCA's review, similar proposals were under consideration by the European Securities and Markets Association ("ESMA"). In this regard, the ESMA (the European regulator whose Members are the European Union's financial markets regulators in each of the 28 member states) was reviewing the use of soft-dollars as part of a wider directive intended to establish standards of conduct, organizational requirements, and regulatory reporting requirements. The directive is called, "Markets in Financial Instruments Directive II" ("MiFID II") and "Markets in Financial Instruments Regulation" (MiFIR").

In December 2014, the ESMA released its long-anticipated technical advice on the implementation of MiFID II.[2] The ESMA's report, while not recommending an outright ban of soft-dollars, proposed very stringent conditions on the ability of managers to pay for research with client commissions. Shortly after the ESMA published its report,

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[1] Discussion Paper DP/14/3, Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research. (July 2014)
[2] ESMA, *Final report: ESMA's Technical Advice to the Commission on MiFID II and MiFIR* (19 December 2014)

the FCA, issued a "Feedback Statement" which applauded the report and indicated it both supported the ESMA position, and once enacted, would adopt similar language with respect to the UK financial market system.[3]

This has now come to pass. On April 7, 2016, the ESMA published its final rules governing the use of commissions for purchasing research. These rules were formally codified in the *Commission Delegated Directive (EU), supplementing Directive 2014/65/EU* ("Delegated Acts")[4]. Although the European Parliament must still formally adopt these rules (after which the regulatory agencies of the various Member States will enact local regulations) those steps are essentially now viewed as a formality.

As discussed in greater detail below, the Delegated Acts will dramatically change the process by which managers obtain investment research, not only in Europe and the UK, but globally. While it's unlikely the Delegated Acts will prompt immediate regulatory reform in the US (since US soft-dollar practices are governed by Section 28 (e), which would need to be amended by Congress before the SEC could fundamentally alter their current policies), whenever managers offer services on a global basis, changes in one region often compel the manager to modify their policies and procedures for clients across all regions. Indeed, some firms have already instituted policies and procedures designed to bring their previous soft-dollar practices in-line with the new legislative mandates.

A regulatory "sea-change" in purchasing investment research!

Just as the "supposedly drowned" King Alonso was metamorphosed into something richer and better in Shakespeare's *The Tempest*,[5] the Delegated Acts have worked a sea-change on the traditional practice of managers using soft-dollar commissions to buy research. In relevant part, the Delegated Acts no longer permit managers to simply pay higher commission rates in order to build up their soft-dollar credit accounts (whether as bundled commissions with each respective broker, or in CSAs). Rather, each manager must either:

1. Purchase their desired research with the manager's own money, or
2. Establish a "Research Payment Account" (for use by the manager to purchase its desired research), and annually notify each respective client how much money the manager will be taking from that client to fund the manager's Research Payment Account ("RPA").

For managers choosing to use their client's money to purchase research (i.e. by establishing an RPA), the Delegated Acts dictate rigorous procedures that must be followed. The procedures are designed to ensure that the amount of funds transferred into the RPAs are calculated, managed, and used strictly in the client's best interest.

Chief among these procedural requirements is that managers must have: a definable process for pricing each research service they want to purchase with client assets, the amount charged to the client must be linked to the benefit received by the specific product/strategy used by the client, and the cost of that research must be fairly allocated among the manager's clients. Most important of all, the manager must annually provide this information to the client, *and obtain the client's approval*, <u>prior</u> to using the client's funds. A detailed list of the numerous steps managers must take before using client funds to purchase research is attached as Appendix A.

It should be noted that additional guidance is still needed from the EU Member States, regarding the mechanics by which the RPAs can be funded. In particular, the Delegated Acts make clear that moneys can be transferred into the RPA in lump sum payments (from the client's Fund), or alternatively, accumulated in the RPA through the use

[3] FSA Feedback Statement on DP14/3 – Discussion on the use of dealing commission regime. (February 2015).

[4] Commission Delegated Directive (EU) …/… of 7.4.2016 – supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safekeeping of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits. (hereinafter "Delegated Acts)

[5] *Full fathom five thy father lies, / Of his bones are coral made, / Those are pearls that were his eyes, / Nothing of him that doth fade, / But doth suffer a* ***sea-change****, / into something rich and strange, / Sea-nymphs hourly ring his knell*, . William Shakespeare, <u>The Tempest</u>, Act I, Scene 2.

of the client's commissions. However, the mechanics of how either approach will actually work in practice, has yet to be clarified.

That said, from the perspective of the asset owner's new fiduciary responsibility, Zeno views the mechanical differences between the two RPA funding approaches as largely, a distinction without a difference.

Bottom-line, regardless of the mechanism by which the asset owner's funds are transferred from the asset owner's account to the manager's RPA, the asset owner is the guardian of the Fund's assets. Consequently, once the asset owner is put on notice that the manager intends to purchase research (or any other service for that matter) with Fund assets, it is the asset owner's fiduciary responsibility to ensure that such purchases are reasonable, consistent with fund policies, and in the best interests of the Fund's participants and beneficiaries, or shareholders.

As the plan fiduciary, asset owners of course have an absolute right (should the asset owner choose) to prohibit their managers from using Fund assets to purchase any research. Indeed, many market participants, including numerous managers themselves, feel that the acquisition of research should be paid strictly from the manager's asset management fee. At the same time, most asset owners have historically allowed their managers to purchase investment research using Fund commissions - with the implicit understanding that such expenditures are not excessive. For better or worse, going forward, these "unspoken understandings" will no longer be permissible.

Accordingly, asset owners should be prepared to make explicit "informed decisions," as to whether they are comfortable with the amount of additional funds each manager is requesting for research (regardless of the transfer mechanism).[6] Happily, as noted above, the ESMA and FCA anticipated this need, and in drafting the Delegated Acts, included a number of critical disclosure requirements by managers designed to facilitate the asset owner's decision-making process.

Making informed decisions about research-budget requests

From Zeno's perspective, the ability to exercise appropriate oversight (if/when asked to approve annual RPAs), is predicated on a general understanding of the pros and cons of traditional soft-dollar arrangements. More to the point, asset owners should initially determine, ex-ante, their general views regarding permitting their managers to purchase research with Fund assets (over and above the manager's asset management fee).

To the extent, an asset owner doesn't simply prohibit such practices; the asset owner should then be prepared to evaluate the reasonableness of the manager's research budget request (which will be transferred into the manager's RPA, once approved). In making this assessment, the asset owner should be comfortable that for each requested research service, two fundamental criteria are met:

1. There is an objective link between the requested research and an articulated benefit to the Fund; and
2. The pro-rata amount charged to the Fund (for that specific research service) is reasonable, given the manager's other clientele who also utilize that research and the value of that research to the strategy/product in which the client is investing.

Additionally, if a manager wishes to fund its RPA through the use of commissions, Zeno believes the asset owner should also be familiar with the requesting manager's current trading policies and practices, and the execution quality that manager obtains on its trades. This requires both qualitative and quantitative due diligence, on a manager-specific basis.

The qualitative analysis is particularly helpful in determining the Fund's basic policy regarding the use Fund commissions (as opposed to the manager's own money) to purchase investment research, and the Fund's

[6] It also follows that, once the asset owner becomes aware of such an impending transfer of funds, inaction or inattention on the part of the asset owner will most likely be deemed, implicit acquiescence to the manager's research budget request.

subsequent degree of comfort regarding the manager's RPA construction, and its management of the Fund's research budget. To this end, primary areas of qualitative focus include:

- A comprehensive list (and description) of each research service the manager plans to purchase with Fund assets, and the cost for each service (both overall and the Fund's pro-rata share).
- The formula and methodology by which the manager determines the value and purchase price of each respective research service, for each strategy/product in which the Fund utilizes the manager.
- The formula and methodology by which the manager determines the Fund's pro-rata share of the overall cost of each respective research service, for each strategy/product in which the Fund utilizes the manager.
- The manager's general views, practices, and policies regarding soft-dollars (for non-EU/UK clients); and the degree to which the manager purchases soft-dollar services (for non-EU/UK clients)?
- How does the manager coordinate the trading of different client accounts participating in the same investment product, if some clients prohibit that manager from using Fund assets to buy research, while others allow RPAs?
- What does the manager view as reasonable commission rates (for both execution-only and research-related trades); and under what circumstances would the manager be willing to pay higher rates?
- A description of the manager's general trade process from the point in time when an investment decision was made, through the actual execution of the trade.
- The manager's ownership structure and whether it has a broker/dealer affiliate.
- The process by which the manager determines which brokers to allocate trades to, and whether it has any relationships/affiliations with those brokers?
- What actions, if any, does the manager take if they determine a particular broker/dealer did not provide best execution on certain trades?
- How does the manager calculate and assess the costs incurred on their trades, and whether they received best execution from the broker/dealers (particularly on soft-dollar trades)?

A careful assessment of the above qualitative information will in most instances be sufficient for determining the Fund's comfort level in allowing its managers to purchase investment research with Fund assets, and the Fund's general degree of comfort regarding the manager's construction and management of the Fund's specific research budget and RPA. However, for several reasons, quantitative analysis is also recommended to supplement the insights gleamed from the qualitative data. The two primary reasons follow below.

Implicit in the premise behind the Delegated Acts is the assumption that research costs will likely decline as managers are forced to systematically examine and justify each research expenditure. From a quantitative perspective, this implies that asset owners should in many instances anticipate a savings. In addition, to the extent a manager prefers to purchase its research with its own money (and perhaps concurrently request an equal increase in its asset management fee), or fund its RPA through a lump sum transfer of funds, the asset owner may experience a redistribution of costs (i.e. lower commission costs vs. higher asset management fees or other expense line-item).

For this reason, Zeno recommends that, particularly in the initial years, asset owners should quantitatively compare the commissions and asset management fees that their Funds incurred in the year prior to the Delegated Acts' effective date vs. the years following their effective date. This comparison will help identify any savings (or costs) incurred by the Fund, as a result of the procedural changes. And in instances where the Fund doesn't realize a savings, further investigation is warranted.

Aside from quantitatively tracking the research-related costs, asset owners should quantitatively evaluate the execution quality their managers obtain on the Fund's trades. As noted in Zeno's earlier article, part of the genesis for the Delegated Acts was the UK and EU regulators' concerns that historically, managers may have sent trades to various brokers in order to build up soft-dollar credits, rather than "best execution." If those concerns have merit, once the Delegated Acts go into effect, asset owners should experience further savings as execution efficiency improves (since managers will no longer be incented to use brokers in return for research as opposed to execution quality).

As with evaluating commission costs, comparing a manager's execution quality and trading efficiency, both before and after the Delegated Acts go into effect, will help identify the degree to which the Fund benefited. And in instances where execution quality goes down, further investigation is warranted.

Similarly, for managers that fund their RPAs through commissions (as opposed to taking a lump sum from the Fund's assets), asset owners should compare the execution quality obtained on execution-only trades vs. the execution quality of trades whose commissions included an allocation for the manager's RPA. This will help validate that the managers aren't inadvertently receiving weaker executions on trades involving research payments.

Ideally, both the asset owner and the manager could also assess whether the overall amount a manager paid for each respective research service was reasonable *relative to what other managers paid* for the same, or similar, type of research. Unfortunately, such a Research Fee Universe does not currently exist. However, several firms including Zeno, are actively exploring the feasibility of such a tool. Over the next several months look for more communications from Zeno in this regard.

Conclusion

Under the Delegated Acts of MiFID II, asset owners will finally have full transparency as to the amount and purpose of all monies taken from their Fund (by their managers) to purchase investment research. We believe this transparency will benefit asset owners not just as a risk-reduction exercise, but potentially translate into tangible cost savings for the Fund. A number of recent studies provide anecdotal evidence supporting the common-sense notion that, when using traditional soft-dollars, managers spend unnecessary client funds to purchase unnecessary research.

Specifically, in May of 2015, Westminster Research Associates published its findings from a survey of 278 firms in the financial sector, including over 150 investment managers. When the managers were asked if they would use more, less, or the same amount of research should they be required to use their own instead of their client's money, 67% of the managers indicated they would use less.[7] Similarly, in a survey of over 100 European managers published by Bloomberg in April, 2016, over 80% of the managers indicated their research spend would either stay the same (52%), or decrease (29%).[8]

Does this mean managers will be making less informed investment decisions? We believe not. Rather, in many cases, historical soft-dollar arrangements engendered an environment in which managers acquired research without rigorously evaluating the degree to which it truly contributed to the firm's investment-making decision process. In the new regulatory environment, this will no longer be permitted.

Indeed, Frost Consulting, a UK consulting firm that advises UK asset managers on how to comply with MiFID II's commission unbundling mandates, has quantified the level of inefficiency imbedded in traditional soft-dollar practices. Specifically, Frost Consulting maintains that managers who switch from the traditional turnover driven soft-dollar approach, to the targeted-research approach mandated by the Delegated Acts, usually reduce their total annual research spend by upwards of 15-20%.

In this regard, current estimates of the cost of research paid by managers (with their client's money) exceed $20 billion per annum. A 15% reduction (through more efficient and effective research-budgeting procedures) would represent an initial savings of $3 billion each year flowing directly back to asset owners.

[7] Westminster, 2015 CSA & Research Usage Survey, May, 2015.
[8] Bloomberg Tradebook, Special Report: Paying For Research Pre and Post MiFID II Guidance, 2016

Further, the switch from acquiring research as a function of trade volume, promises even greater savings when taking into account a manager's Cumulative Annual Growth Rate ("CAGR"). Specifically, most managers historically allocated research budgets on a "broker vote" basis, whereby key personnel within the manager decide on the percent of the manager's trade flow each broker should receive. The commissions associated with that trade flow represent bundled compensation to the broker for both execution and research. Assuming a broker's quality of service for the manager remained constant, the broker could expect to receive approximately the same percentage of trade flow, year-over-year.

Of course, if overtime, that manager's AUM grew (whether through performance or new clients), and/or the share prices of the traded stocks increase, the <u>dollar value</u> of the non-US commissions sent to that broker could grow exponentially[9] - *notwithstanding the fact that the research services delivered remained the same*. Switching to the new approach of assigning a hard-dollar price to each research service, and only purchasing those services the manager actually uses, eliminates this problem.

However, these savings will not be achieved without effort. They will only be realized by those managers who employ rigorous research-budgeting efforts; *and the asset owners who hold their managers to such standards*. And in this regard, it is worth noting that the April 2016 Bloomberg study found that 61% of the polled managers had not yet begun to consider how they'll pay for research under MiFID II, let alone put a rigorous process in place.

In summation, the use of client assets to purchase research (whether via a lump-sum transfer into the manager's RPA, or the payment of higher commissions that are subsequently routed to the RPA), has fiduciary implications for both the manager and asset owner. Under MiFID II, a manager has a fiduciary duty to: invest their client's assets prudently, seek best execution when executing trades, and only purchase research with the client's money that adds an appropriate level of benefits to the client's Fund. At the same time, asset owners have a fiduciary obligation to monitor their managers for compliance with these regulations and safeguard the assets of their Funds.

Bottom-line, acceptance or rejection of a manager's proposed RPA is a new fiduciary responsibility for every asset owner. That decision should be predicated on a systematic assessment that the manager's proposed research budget is reasonable. This in turn, requires the periodic collection of the above data, so as to enable the:

- Quantitative analysis of the execution quality achieved on trades involving commissions earmarked for the managers RPA, and
- Qualitative evaluation of the manager's research budgeting practices and policies.

Going forward, these standards will increasingly be viewed as fiduciary "best practices."

To learn more about the risks associated with unbundled commissions and research payments, and the steps asset owners can take to best manage those risks, click here to contact Zeno.

[9] Since non-US commissions are paid in basis points, if the share price of a non-US security increases, so does the dollar amount of the commission.

Appendix Required actions by managers (if purchasing research with their client's funds)

Pursuant to the Commission Delegated Directive (EU) …/… of 7.4.2016 ("Delegated Acts"), managers will be required to provide each client with a proposed research budget, to be transferred into the manager's Research Payment Account ("RPA"), on an annual basis (or more frequently if desired). In submitting their proposed RPA budget to a client, the manager must detail each service the manager wants to buy in the upcoming year, and the pro-rata portion of each service's cost, for which that client will be responsible. The proposed research budget must be reviewed and agreed to by the client, before the manager can use those funds.

Further, to be permitted under the Delegated Acts, a manager must adhere to a number of very specific requirements. These requirements address how the manager's proposed annual research budget must be constructed, the administrative and operational requirements of the RPA, permissible practices for funding the RPA, as well as disclosure requirements to clients. In particular:

- **With respect to how the overall research budget is determined, for any given client, the manager must:**
    - Limit the research budget charged to each respective client to the specific research services used by that client.[10]
    - "*Regularly assess the quality of the research purchased, based on robust quality criteria and its ability to contribute to better investment decisions*."[11]
    - Furthermore, the process by which the manager assesses "*the quality of the research being purchased, based on robust quality criteria and the research's ability to contribute to better investment decisions*," must be codified in a written policy. The written policy must also address the extent to which the research benefits the client's portfolio (taking into account the investment strategy utilized for the client). The written policy must further also address the process by which the manager allocates their research costs fairly among its various clients.[12]
    - The manager's senior management must exercise oversight of the internal research budgeting process, to ensure the research budget is managed and used in the best interests of the manager's clients. In doing so, the manager must utilize suitable controls, including a, "*clear audit trail of payments made to research providers and how the amounts paid were determined with reference to the quality criteria*."[13]
    - Before the RPA can be funded, the client must agree to: the research budget they are being charged, and the frequency with which the research payments will be taken from the client's Fund (e.g. in periodic lump sum payments or via commissions). Further, subsequent increases in the research budget can only occur if the manager first provides, "*clear information to clients about such intended increases*[14]."
    - Lastly, the manager cannot use a client's research budget to fund the manager's internal research.[15]

- **With respect to administering and funding its RPA, the manager is:**
    - Precluded from establishing/funding a client's research budget through the use of commissions linked to the volume and/or trade value.[16]
    - The total amount of research charges accumulated cannot exceed the agreed upon research budget.[17]

[10] Delegated Acts, Article 13, Sections 1(b)(ii), and 2(a).
[11] Id. at Section 1(b)(iv)
[12] Id. at Section 8.
[13] Id. at Section 6.
[14] Id. at Sections 1(b)(ii), and 5.
[15] Id. at Section 6.
[16] Id. at Section 2(b)
[17] Id. at Section 4.

- If a surplus exists in a client's RPA as of the end of the budget period, the manager must rebate those funds to the client, or apply the excess funds to offset the client's next research budget.[18]
- While the manager is ultimately responsible for the RPA, it may delegate the administration of the RPA to a 3rd party (if doing so would facilitate the purchase of research and payment of research providers).[19]

- **With respect to information the manager must disclose to its clients, the manager is required to:**
  - Inform each client of its, "*budgeted amount for research, and the amount of the estimated research charge.*"[20]
  - Annually inform each client of the total costs that client incurred for the research.[21]
  - If the RPA was funded through the use of commissions, the manager must indicate the portion of the commissions that were attributed to the client's research charge.[22]
  - Provide copies of its written policy that, assesses "*the quality of the research being purchased, based on robust quality criteria and the research's ability to contribute to better investment decisions*," addresses the extent to which the research benefits the client's portfolio (taking into account the investment strategy utilized for the client), and addresses the process by which the manager allocates their research costs fairly among its various clients.[23]
  - Lastly, upon request by a client, provide a summary of the vendors who received payments from the RPA, the total amount each research vendor was paid over a defined period, the research benefits and services received by the manager, and how the total amount ultimately spent from the RPA compares to the proposed RPA budget originally established by the manager and client at the beginning of the year (and noting any rebate or carryover if residual funds remain in the RPA).[24]

[18] Id. at Section 5.
[19] Id. at Section 7.
[20] Id. at Section 1(c)(i)
[21] Id. at Section 1(c)(ii)
[22] Id. at Section 3.
[23] Id. at Section 8.
[24] Id. at Section 2.