

28 January, 2025

By Online Submission

European Securities and Markets Authority
201-203 rue de Bercy
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France

Re: Consultation Paper, Draft technical Advice to the European Commission on the amendments to the research provisions in the MiFID II Delegated Directive (ESMA35-335435667-5979)

Dear Sir/Madam,

MFAⁱ appreciates this opportunity to represent the views of the global alternative investment industry in this written response to the European Securities and Markets Authority's ("ESMA's") Consultation Paper on proposed amendments to the research provisions in the MiFID II Delegated Directive (the "**Consultation Paper**").ⁱⁱ MFA supports efforts to align the EU inducements regime with that of the US and others to arrive at a globally consistent approach to research payments. We have set out our responses to the relevant questions of the Consultation Paper in the Annex hereto.

In summary, MFA welcomes the proposed new option to allow for the possibility of joint payments for research and execution services, including for issuers with market capitalisations above €1 billion, alongside the existing research payment options. MFA however is concerned that overly prescriptive conditions required to use a joint or "bundled" payment option may function as a deterrent to its adoption by investment firms. The failure of firms to embrace a joint payment option may hinder the achievement of the objectives of the Consultation Paper, including ESMA's goal to help

ⁱ Managed Funds Association ("**MFA**"), based in Washington, D.C., New York City, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest it, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 180 fund manager members, including traditional hedge funds, private credit funds, and hybrid funds, that employ a diverse set of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors diversify their investments, manage risk, and generate attractive returns throughout the economic cycle.

ⁱⁱ ESMA, Consultation Paper, Draft technical Advice to the European Commission on the amendments to the research provisions in the MiFID II Delegated Directive (ESMA35-335435667-5979) (28 Oct. 2024) (avail. at https://www.esma.europa.eu/sites/default/files/2024-10/ESMA35-335435667-5979_Consultation_Paper_on_Technical_Advice_on_MiFID_II_DD_research.pdf).

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revitalise the market for investment research while remaining aligned with its investor protection objectives.ⁱⁱⁱ It furthermore is imperative that the requirements contemplated by the Consultation Paper align with existing, longstanding practices of execution firms in the EU, US, and abroad for the goals of the Consultation Paper to be fully realised. We highlight these matters in our responses in the attached Annex.

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MFA appreciates the opportunity to provide these comments to ESMA in response to the Consultation Paper. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact Rob Hailey (rhailey@mfaalts.org), Jeff Himstreet (jhimstreet@mfaalts.org), or the undersigned (jhan@mfaalts.org).

Respectfully submitted,

/s/ Jennifer W. Han

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ⁱⁱⁱ See *id.* at § 4.3, ¶ 8 (cost-benefit analysis).

ANNEX

**Question 1: Do you agree with the proposed approach? Or would you prefer a more or less detailed approach?
Please state the reasons for your answer.**

MFA Response

MFA supports the ESMA proposal¹ to introduce the additional payment optionality for investment research that would include the use of joint, or bundled, research and execution payment options. Many EU managers are based in, or have considerable operations, in the US and have for many years had robust procedures to allow for the joint payment of research and execution that are consistent with the manager's fiduciary and best execution obligations to its clients, which for MFA members are the private funds managed by the investment management firm. MFA also has welcomed the possibility of payment optionality for investment research in the UK and expressed supported for the objectives of a recent consultation published by the FCA.²

MFA concurs with a number of the observations noted in the Consultation Paper as underlying drivers for the proposal. In particular, MFA agrees that the current investment research payment options – payment out of own resources (the “**P&L Model**”) or from a research payment account (“**RPA**”) – could benefit from additional flexibility for investment firms to choose how they organise and budget payments for execution and investment research.

We appreciate ESMA's periodic reconsideration of the investment research rules as it seeks to improve the ability of managers to use investment research. One result of this periodic assessment was the 2021 modifications in 2021 of the research rules by Directive (EU)2021/338 of the European Parliament and Council,³

¹ ESMA, Consultation Paper, Draft technical Advice to the European Commission on the amendments to the research provisions in the MiFID II Delegated Directive (ESMA35-335435667-5979) (28 Oct. 2024) (avail. at https://www.esma.europa.eu/sites/default/files/2024-10/ESMA35-335435667-5979_Consultation_Paper_on_Technical_Advice_on_MiFID_II_DD_research.pdf).

² Financial Conduct Authority, Consultation Paper, Payment Optionality for Investment Research (CP 24/7) (April 2024) (avail. at https://www.esma.europa.eu/sites/default/files/2024-10/ESMA35-335435667-5979_Consultation_Paper_on_Technical_Advice_on_MiFID_II_DD_research.pdf). See also Letter from MFA to FCA, Payment Optionality for Investment Research: Consultation Paper (CP 24/7) (5 June 2024).

³ European Parliament and Council, Directive (EU) 2021/338 (16 February 2021) (amending Directive 2014/65/EU as regards information requirements, product governance and position limits) and Directives 2013/36/EU and (EU) 2019/878 (as regards their application to investment firms) (avail. at <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021L0338&qid=1735396191122>).

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which permitted bundled research and execution payments for small- and middle-sized companies with a market capitalisation below €1 billion (“**2021 Modifications**”).

While these amendments were intended to help incent investment management firms to receive research on this important segment of the market, the use of bundled research and execution in this important market segment has gone largely underutilised. Investment management firms, by 2021, already either decided to use the P&L Model, paying for research from the firm’s own balance sheet, or developed the necessary administrative, operational, and technological controls to institute and manage an RPA, or some combination of the two. The investable universe of issuers that meet the €1 billion threshold to be eligible for the 2021 Modifications for many investment firms is insufficient in size for firms to justify developing and implementing a bundled research payment infrastructure and as a result, investment firms used either the existing P&L Model and/or RPA to pay for research for these smaller- and middle-sized issuers.

The Consultation Paper notes 3 options under consideration by ESMA as potential modifications of the joint payment method – (1) do nothing, preserving the 2021 Modifications for smaller issuers but not extending the joint payments method to research covering other issuers; (2) impose detailed, prescriptive requirements as conditions of allowing an investment firm to engage in joint, bundled payments; or (3) permit joint payments for research covering all issuers and require “high-level” requirements on investment firms seeking to use joint payments.⁴

MFA would not support Option 1 of Section 3.1 of the Consultation Paper, which would be to do nothing and continue with the current approach of only allowing joint research and execution payments for issuers not exceeding the €1 billion market capitalisation threshold. MFA supports ESMA’s decision to not pursue Option 1. The lack of a joint research and execution option in the EU marketplace in our view has negatively impacted EU asset managers’ ability to procure research on an international basis, to the potential detriment of investment performance and EU asset managers’ ability to compete on a global basis. MFA also agrees with observations that the uptake by firms of the RPA model has been limited, due to the operational complexity and resource-intensive nature of maintaining an RPA.

That said, MFA also supports the underlying rationale for the unbundling of investment research, which has resulted in greater transparency of execution and research costs. To that end MFA is supportive of the proposed new payment option as an additional option to the P&L model and the RPA model, rather than having the proposed new payment option simply replacing the existing models.

MFA cautions against an overly prescriptive set of conditions that would be required to use the joint payment option, which could serve as a deterrent from using the joint payment method at all. MFA therefore does not support Option 2 of Section 3.1 of the Consultation Paper, which would impose a contractual requirement between the research provider and the investment firm, including the total cost of the research. We have

⁴ See note 2, *supra* (¶ 10).

expressed similar concern to non-EU consultations that had permitted bundling but only conditioned upon a labyrinth of unnecessarily prescriptive conditions.⁵

Execution firms typically do not allocate execution costs between execution and research and historically have been unwilling to do so when asked. They moreover historically have refused to reduce trading costs for investment managers that opt out of receiving the execution firm's research.

MFA appreciates ESMA not pursuing Option 2 as well, as such an approach would in practice limit the universe of executing brokers to provide research to those willing to break out each representative component of the bundled services provided by the executing broker. The effect is that the investment firms would have fewer execution firms to consider, which could pose best execution risks for the firm. The quality of the research provided would also likely suffer, as those firms that were willing to break out execution and research components may not be "best in class" at either, but the investment management firm would have little choice but to go with only those firms willing to provide an execution/research allocation to the firm. Under these conditions, the investment management firm would likely forego the bundled approach and continue with the RPA/P&L Model approach(es) currently in use.

As noted, many MFA member firms have years of experience using joint or bundled research and execution options and have developed robust and time-tested disclosure and controls that ensure that managers are fulfilling their fiduciary and best execution obligations when receiving research and execution for a bundled payment. These controls have been the subject of examination and inquiry for decades and represent industry best practices. Imposition of rigid, overly prescriptive conditions is unnecessary.

MFA therefore supports ESMA's decision to pursue Option 3, with modification as we suggest below, which would amend Article 13 of (EU)2017/593⁶ to provide high-level requirements to the different payment options, without imposing narrow, inflexible, and unnecessarily detailed requirements. MFA appreciates that the Consultation Paper avoids the requirement to adhere to overly rigid and often unworkable conditions to use bundled, joint research and execution payments. The modifications MFA suggests below are intended to make the option usable for EU managers procuring execution and research services from non-EU execution providers.

We propose modification to paragraph 5 of Section 2.2 to make clear that the investment firm is the "provider" of the research even if the execution firm procures the research from a third party. Many execution firms, in addition to creating their own research, also subcontract with third parties to provide additional research coverage where the third party may possess research skills or coverage beyond the execution firm's staffing or

⁵ See MFA Comment Letter, *supra* note 2.

⁶ European Commission, Delegated Directive (EU) 2017/593 (7 April 2016) (avail. at <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L0593>).

capabilities. Investment firm clients benefit from this research and the investment firms should be able to receive this third-party research through a joint payment relationship with the execution firm.

We also recommend needed flexibility around the contractual requirement to detail the total cost of research to reflect the differing approaches taken by execution firms based on governing laws and practices. Execution firms typically do not provide this execution vs. research cost breakdown. An overly detailed approach furthermore would give rise to challenges where the firm engages providers based in jurisdictions such as the US that do not require brokers to unbundle research and execution costs. The US execution firm therefore is highly unlikely to suddenly develop research expense allocation procedures to allow for it to separately identify research costs.

MFA member experience is that, when asked, execution firms decline to provide a detailed breakdown. The fact that execution firms historically have resisted providing a cost breakdown of the execution and research components makes the requirements of Paragraph 5.a) of the Consultation Paper challenging. Paragraph 5.a) requires the agreement between the investment firm and the execution/research provider to “establish[] a methodology for remuneration, including how the total cost of the research is generally taken into account” Absent modification of Paragraph 5.a), EU asset managers would continue to be prevented from engaging research providers in the US and would continue to rely on the RPA/P&L Model methods to receive research from US execution firms.

MFA recommends that Paragraph 5.a) be amended to state that the agreement establish a methodology “to the extent required by applicable law of the third-party provider of execution services and research” to allow EU managers to engage US firms for execution and research, in addition to execution firms in other jurisdictions that are not required to separately breakout the execution and research components.

Question 2: Do you agree with the introduction of new paragraph 1b in Article 13 of Commission Delegated Directive (EU) 2017/593? Please explain why.

MFA Response:

MFA member firms, as part of their existing controls, periodically assess the quality of the research they receive, regardless of whether they use an RPA, the P&L Model, joint payments, or a combination thereof. This review is typically part of an investment firm’s periodic review of execution brokers and incorporated into the firm’s regular compliance workstreams.

When evaluating the quality of the research provided by the execution firm, it is important to consider the quality of the research in the context of the overall services the investment firm receives from the execution firm – often times the relationship is deeper and broader than merely execution and research and may include custody, a broader trading relationship (e.g., acting as a derivatives counterparty), securities lending, treasury and cash management, order handling, and other services. For this reason, MFA cautions against requiring a comparison of *solely* the research services provided by the execution firm against a third party research firm that provides only research – while the research of the third party firm may be comparable to the research

provided by the execution firm, the third-party research firm is likely unable to provide the investment firm with the other services provided by the execution firm.

In addition, if the investment firm were to seek research from a third-party firm and pay for that research either through an RPA or P&L Model, it is unlikely that the execution firm would reduce the total execution costs to reflect the fact that it is providing “execution only” services and not providing research to the investment firm. Such an approach would create a best execution risk for the investment firm since it now would be paying for research via an RPA or P&L Model in addition to the same execution costs it was paying when it was receiving investment research. MFA supports optionality in research and permitting bundled research and execution services but not mandating that a manager adopt any particular approach.

It therefore is important that any comparison of research quality between the execution firm and a third-party research provider be on a “like-to-like” basis.” A preferable approach would be for the investment firm, should it have concerns with the quality of the research provided by the execution firm, to raise those issues with the execution firm and then proceed accordingly and consider modifying or severing the relationship with the execution firm.

Question 3: If you do not agree with the introduction of new paragraph 1b in Article 13 of Commission Delegated Directive (EU) 2017/593, please provide alternative suggestions and/or explain how investment firms operating a research payment account currently assess the quality of research purchased (Article 13, point 1(b)(iv) Delegated Directive).

MFA Response

Please see MFA’s response to Question 2, above.

Question 4: Do you agree that, when conducting the annual assessment provided in new Article 24(9a)(c) of MiFID II, an investment firm could be required to include a comparison with potential alternative research providers? Please state the reasons for your answer. Please also provide feedback on the availability of free trials for research services and why they may or may not be appropriate for investment firms to fulfil their obligations under Article 24(9a)(c). If free trials are not appropriate, which other methods could be used for comparison?

MFA Response

Please see MFA’s response to Question 2, above.

MFA member’s experiences are generally that “free trials” for research are not indicative of the quality of the research the investment firm could reasonably expect to receive on an ongoing basis. In addition, the execution firm is unlikely to provide access to its research staff to an investment firm that is receiving a free trial. The execution firm’s analyst expertise is an important component in the overall assessment of the quality of

research. Free trials also tend to be of exceedingly limited duration and do not afford the manager the needed time to reasonably assess the quality of research over multiple quarters.

Question 5: Do you agree with the introduction of new paragraph 10 in Article 13 of Commission Delegated Directive (EU) 2017/593? Please state the reasons for your answer.

MFA does not oppose the proposed requirement that an investment firm that receives execution and research services for a joint payment to document the relationship in an agreement with the execution/research firm. The joint payment also should be subject to the investment firm's general obligations to seek best execution in client trades, as currently is the requirement in the US and other jurisdictions permitting joint, bundled payments.

In addition to the requirement that the payment for joint research and execution services be consistent with the investment firm's best execution obligations, new paragraph 10(a) of Article 13⁷ also would require that, where an investment firm pays jointly for execution and research, the agreement prevents that the investment firm would pay "substantially" more for the research than if the manager paid for the research separately through a RPA or P&L Model.

The inclusion of the term "substantially" in new Paragraph 10(a) adds subjectivity, ambiguity, and uncertainty to an investment firm's best execution analysis and as discussed below, is unnecessary given the investment firm's existing fiduciary and regulatory obligations. As the Consultation Paper notes, to assess whether the manager is paying "substantially" more for research than if the investment firm pursued an unbundled approach requires that the execution and research firm provide an allocation of the bundled payment to the investment firm – that is, the percentage of a bundled cost that constitutes research versus execution. Execution firms as discussed above typically do not provide such a detailed breakdown and historically have been unwilling to do so. In addition, if an investment firm elects to forego the receipt of research services, the execution firm invariably keeps its overall transaction costs unchanged even though the investment firm is no longer receiving research.

MFA therefore recommends that, provided the investment firm meets its best execution obligations as would be required by new paragraph 10(b) of Article 13 of (EU)2017/593, new paragraph 10(a) is unnecessary. If the investment firm has determined that its joint payment for research and execution services is consistent with its best execution obligations, it impliedly has concluded that it is not paying substantially more for research received through a bundled approach than if the investment firm contracted separately for research. Paragraph 10(a) also is problematic when considering existing bundled arrangements as the proposal to cap or tier fees on a per-broker basis would be unworkable.

⁷ See note 1, *supra*.

Question 6: Do you think that any further requirements or conditions applicable to investment research provided by third parties to investment firms should be introduced in the proposed amendments to Commission Delegated Directive (EU) 2017/593? Please state the reasons for your answer.

MFA Response

Please see MFA's responses above.