Briefing Paper

MiFID II - Legal status of funds held in Broker Omnibus Accounts being used in the context of the operation of Research Payment Accounts

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INTRODUCTION

This paper comments on the impact post-MiFID II of the use of Broker Omnibus Accounts (BOAs) as part of a Research Payment Account (RPA) accrual process in the UK.

In this paper a BOA shall refer to any form by which a broker may hold money during the sweep period (as defined below) which may be in the form of an omnibus account or on its own balance sheet. The paper only covers the implications of the use of a BOA – it does not cover the other aspects of the MiFID rules relevant to research unbundling and the use of RPAs, nor does it cover the approach of non-UK NCAs.

A BOA is an "account" operated by a broker, which may merely be an internal books and records entry tracking the movement of sums of money that will, in time, be due to be paid to an RPA, or it may be a separate account. Brokers are likely to be trading for a large number of managers. In order to enable a broker to keep track of amounts which might be required to be paid into an RPA, it may wish to make use of a BOA so that the sums are paid from its main books and records into an account (owned and operated by the broker) to enable calculations to be made and reconciliations to be undertaken, in order that the correct amount can then be paid, on time, into the relevant manager's RPA. Some managers are expected to run multiple RPAs, or multiple sub-accounts within an RPA, in order to reflect different underlying management strategies which are being undertaken. Therefore, because the precise destination of the relevant RPA (or RPA sub-account) may not be known at the time that the trade is undertaken, a BOA will enable Brokers and Managers more efficiently to organise the process prior to any amount becoming payable to the Manager's RPA under FCA's rules.
There are two ways in which sums might be paid into an RPA. The first is for a manager to request that the underlying funds made payments into the RPA. The second is that the manager agrees with a broker that, as a result of the unbundling of research charges from execution commissions, when a transaction is executed, a research charge may be levied at the same time as the execution charge, and the Broker pays this sum into the RPA. (There is a third means by which research may be bought, directly from the Manager's P&L, which is outside the scope of this note). A BOA is used only in relation to the second way.

Note: the following analysis is based on FCA's final rules which permit the use of a certain period of time, of up to 30 days (the "sweep period"), during which the monies raised by the research charge can remain owned by the broker prior to the investment manager being under an obligation to ensure that the monies are paid into an RPA.

CLIENT MONEY ANALYSIS

We have considered a number of factors in analysing whether or not a BOA might amount to an account which would need to receive Client Money protection. Those factors are as follows:

- The RPA itself is not a Client Money account from the Broker's or the Manager's perspective. Both FCA and ESMA have made this clear in relevant MiFID II consultation papers. We note that other European regulators (e.g. the AMF) have also come to the same conclusion. There are a number of reasons why

this might be the case. First, regulators are keen that the Manager takes full control of the RPA process. As one of the means of paying for research is for the Manager to pay for it from their own P&L, the thinking may have been that it is important that the money in the RPA is seen as the Manager's money, and subject to their control. Indeed, a typical Client Money arrangement would involve providing Client Money protection for the assets of the underlying clients of a Manager, and not the Manager itself. Further, if an RPA were to be treated as Client Money that would, presumably, mean that a wide variety of Managers would need to obtain permission to hold Client Money and that is not typically the current position. Irrespective of the motivations for concluding that an RPA is not a Client Money account, we note that overall MiFID II makes very important changes between existing CSA arrangements and RPAs, and therefore conclude that a decision not to change this aspect must have been taken after appropriate deliberations.

- As the RPA is not a client money account, it would be curious if any account used in order to facilitate the making of payments into the RPA prior to the sums being due to be paid to the RPA were, for some reason, a Client Money account. In other words, it would not seem logical for regulatory protection to be given to monies prior to being paid to an account where such protections were not enjoyed by the monies when they arrived in that account.

- Various regulators have proposed time periods by which monies must be paid by a Broker into an RPA. Use of these sweep periods acknowledges that the money is receiving no protection at all prior to the expiry of that sweep period. In particular, FCA's proposed rules relating to sweep periods assume that the monies remain owned by the broker prior to the expiry of the sweep period, and therefore the requirements relating to the protection of monies held in an RPA cannot apply prior to the expiry of the sweep period. Whether a Broker chooses to use a BOA (which we note would also be an account for which a Broker would wholly be responsible) or not is presumably irrelevant if the amounts could, in the interim, have been retained on the Broker's balance sheet.

- We note that ESMA's Q&A, question 2 (16 December 2016) contains a description of the legal status of money held in an RPA. The answer starts with a comment that "where an investment firm chooses to use an RPA, this must be funded by a research charge to the client". We also note that the second paragraph of the answer concludes with a description of the importance of making sure that "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" are aligned. We consider answer 2 to be describing the circumstances whereby the underlying client, rather than a Broker, makes the payment into an RPA. This is the because "client" here is the underlying client of the Manager, and whilst it would be possible to align payments from an underlying client of the Manager into the RPA with research charges to be made by the Manager, it is not possible to align the making of payments which result from execution being undertaken by a Broker with the timing of research payments. Execution is undertaken when transactions need to be made on behalf of a fund, and that would not necessarily (or at all) align with the need for a Manager to consume a particular piece of research. In this context, we note that the second paragraph of the answer states "the nature of this deduction of the charge means that once it is deducted from the client, the funds belong to the firm". We think that this makes perfect sense in the context of a payment from an underlying client into an RPA. However, for the reasons described above, we think that that is the extent of the guidance being provided in answer 2, and that the existence of a sweep period means that it cannot be intended that this sentence applies to payments from Brokers into an RPA. In particular, it would not be possible for a charge levied by a Broker to be "funds belong[ing] to the firm" from the instance at which an execution was undertaken. This might result in thousands of transactions a day instantly needing to be segregated, potentially before the broker was told the identity of the relevant RPA into which they were to be paid, and that would defeat the object of any sweep

period which regulators throughout Europe are currently proposing. Further, FCA's implementation of these requirements (COBS 2.3B.15G) make clear that they only apply where the firm (the Manager) charges a client (the fund), which is not the situation where a research charge is levied. Therefore, we think that the treatment of a BOA as not being Client Money is consistent with answer 2 to question 2 of the ESMA Q&A.

- When it comes to determining a point at which monies held by a Broker become due to be paid to a Manager, we note that it would be possible (as happens at present with CSAs) for this to be clarified in a contract between the parties, provided that this agreement did not extend the period beyond the sweep period permitted by the FCA. Doing so would help to make clear exactly when monies became due and payable from the Broker to the Manager. For instance, it could be possible given the 30 day maximum sweep period for the parties to agree that monies would be paid weekly by the Broker to the Manager's RPA. This weekly payment could be made following the completion of a reconciliation process to ensure that the correct amount was being paid. The reconciliation process would need to be completed prior to the expiry of the sweep period. If, for any reason, a Broker had determined that a sum of money was payable into an RPA, and the date for making such a payment had passed, and the Broker was, for any reason, unable to make such a payment, then arguably, at that point, the Broker would be in receipt of monies belonging to its client (the Manager) and the sums would, at that point, potentially qualify for protection as Client Money. (CASS 7.13.39R would require segregation of money due to a client from a firm within one business day unless the money is paid to, or to the order of, the client.)

- We note that FCA's proposed rules require that, where an administrator is appointed to operate an RPA on behalf of a Manager, monies must be "ring-fenced and separately identifiable from the assets of the third party or, where the third party administrator is a bank, are held on deposit for the firm". Similar wording requires it to be clear that creditors must also have no right of access or recourse to monies in the RPA. These requirements cannot be relevant to the processing of monies by the Broker during the permitted sweep period prior to them being sent to the RPA. These requirements apply to the RPA itself, and not to pre-RPA arrangements.

- We note that it is possible for a third party administrator of an RPA to be a bank and to hold the monies on its own balance sheet, providing that they are "held on deposit for the firm [i.e. the Manager]", in accordance with proposed COBS 2.3B.19. The BOA could not be used as the RPA as the RPA has to be an account in the name of the Manager (or an equivalent arrangement).

CONCLUSION

We do not believe that sums held in a BOA should be treated as Client Money provided that the monies are paid into the RPA in accordance with the time periods set out FCA's rules and (provided the agreement complied with those time periods) any agreement between the Broker and Manager.

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