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Event report

Unbundling investment research under MiFID II: How to balance price, allocation and quality

17 January 2018 | 13:00 to 14:30 | Place du Congrès 1, Brussels 1000

MiFID II, which came into effect on 3 January 2018, is set to disrupt the production and distribution of investment research, to impact execution services and, ultimately, to affect costs for investment firms and end-investors. Brokers have to establish a price for investment research separately from execution services. Asset management firms need to develop research budgets for all asset classes, and either pass the costs of research on to clients or absorb the costs themselves. Nonetheless, this will lead to new opportunities for investors to better compare price and quality across products and service levels.

- What are the major challenges for firms in complying with research unbundling (e.g. budgeting – P&L (profit & loss) or RPA (Research Payment Account), allocation, valuation, payment)?
- Are small or large firms affected most by the new rules? What is the approach from an operational standpoint (national, European, global)?
- What is the impact of research unbundling on profitability, liquidity and quality? Are the claims about the potential reduction in the coverage of SMEs warranted?

With the participation of:

Rhodri Preece, Head of Capital Markets Policy EMEA, CFA Institute
Guillaume Berard, Advisor, FSMA
Neil Scarth, Principal of Regulatory Research, FrostConsulting
Angus Bogle, Co-Head of Equities Management, Schroders

Moderated by:
Karel Lannoo, CEO, CEPS and General Manager, ECMI

Note: This report was drafted by Dr Apostolos Thomadakis (Researcher, European Capital Markets Institute). This event report is not a transcript of the speakers' interventions; rather, it should be understood as an interpretation of their views by the author.

Overall summary: MiFID II, with its sweeping reforms to financial markets and business practices, is revolutionising the way in which investment research is produced and distributed, with implications for transparency, performance and competition. Despite the one-year delay in implementating the rules, there are still significant challenges and concerns that need to be addressed: different interpretations by different EU national competent authorities (NCAs), different rules in other jurisdictions, uncertainty regarding the dividing line between research and minor non-monetary benefit. Moreover, the various additional requirements that firms have to comply with in order to use a research payment account (RPA), will make it easier for them to absorb the cost of research through their P&L (profit & loss) account and modify their cost structures by increasing portfolio management fees. These factors may give US asset managers a significant advantage over European managers in terms of size and flexibility of research spending. In addition, the widespread move to P&L in Europe has reduced research transparency (P&L managers have no regulatory obligation to report research spending, unlike managers using client money), while it is likely to increase risks for asset owners. Last but not least, concerns were also expressed about poor coverage and liquidity of small and mid-cap companies, which would have an adverse effect on the cost of capital and the ability to raise capital or list on the market.

Rhodri Preece: MiFID II affects market structures and the trading of financial instruments, and prescribes the conduct of business standards for firms providing investment products and services. The new rules also govern payment for investment research. Traditionally, research is paid for by asset managers via a soft-commission arrangement in which firms pay brokers a bundled commission to receive execution services alongside research. However, the provision of supplementary products or services by the executing broker (i.e. research reports, analyst calls, corporate access, or other non-monetary benefits) can induce the asset manager to route trades to that broker (in order to secure those services), with the potential to either trade more often than is appropriate for the client, or to preclude the use of other brokers who may provide more favourable execution services.

A survey of 330 European investment firms working in the buy-side and involved in using, producing, or procuring investment research revealed three important results. First, on the allocation of research costs, 53% of firms will absorb the cost of research under MiFID II through their P&L account. By contrast, only 15% of firms will charge their clients for research. In particular, larger firms (e.g. those with more than €250 billion AUM) are even more inclined to absorb research costs than smaller firms.

Second, regarding the procurement of research, 78% of respondents expected to source less research from investment banks under MiFID II. On the other hand, 44% expected to source more research in-house on the buy side. So we can expect to see some degree of shift in terms of where research is sourced, perhaps from the sell side to the buy side. Third, fixed-income investors (69%) expect aggregate research plus execution costs to increase as a result of MiFID II, in contrast to equity investors (29%), who generally expect aggregate costs to decrease.

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Guillaume Berard: The new MiFID II investment research requirements embody what could be considered the overall philosophy of MiFID II, according to which clients must know what they pay for. In view of that, the role of firms is threefold. First, to inform their clients fairly, clearly and in a manner that is not misleading; second to identify and manage conflicts of interest; and third, to act honestly, fairly and professionally in accordance with the best interests of their clients. These requirements should be considered in relation to other MiFID II requirements, however, such as the enhanced requirements regarding information on costs and charges, or in relation to inducements.

Given that the majority of firms will absorb investment research costs rather than charge those costs to their clients, three elements are salient here: i) the use of an RPA requires compliance with several requirements, which can impact investment firms' organisation; ii) besides the difficulty of estimating the value of investment research, there are several operational issues, such as the definition of investment research, the identification of staff conducting research and the training of staff in the new MiFID II requirements and the issue of unsolicited research; iii) some investment firms may have had to modify their cost structures following the implementation of MiFID II (e.g. increase their portfolio management fees due to the ban on inducements). This – together with the more detailed disclosure of costs and charges – could make it commercially difficult for those firms to charge research costs to their clients.

Neil Scarth: MiFID II is revolutionising the way information flows between research producers and asset managers in Europe, with implications for both performance and the relative competitive positioning of European managers in a global context. A key question is whether European managers will be at a competitive disadvantage in relation to their US peers. Although a number of large US managers have said they will pay for research via P&L, most will do so for European clients only. Consequently, ~90% of their research budgets will continue to be funded via commissions in the US. By contrast, European managers using P&L to buy fund research will cover more than 90% of their research budget from their own resources. This suggests that US managers may have a significant advantage, both in terms of size and flexibility of research spending. The widespread move to P&L in Europe has reduced research transparency, given that P&L managers have no regulatory obligation to report research spending (unlike managers using client money). Combined with what are often significant budget cuts at P&L managers, MiFID II may have actually increased risks for asset owners.

Regarding asset owners: the critical question is whether the specific strategy in which they are invested has sufficient research access to continue to generate the historical returns that (heavily) influenced the product purchase decision in the first place. The risk to asset owners that regulators sought to address in the pre-MiFID II environment was that their managers might overspend (client money) on research, thereby reducing returns. Post-MiFID II, the risk is that P&L managers

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may cut research budgets sharply, which may reduce returns by far more than the original research 'overspend'. Another related, and critical, 'asymmetry' in the post-MiFID II environment is the relative research costs borne by asset managers versus asset owners. For asset owners (whose managers use client money), the cost of research is very low. By contrast, when the research charge is transferred to the P&L asset manager, the historical (client money) research cost often represents the manager's single biggest expenses.

Angus Bogle: Changes to the research market as a result of MiFID II have caused a lot of disruption; it will take at least 12 months for the market place to settle down. There are still significant challenges to overcome because of the different interpretations by the different NCAs across the EU, as well as the different rules in other jurisdictions such as Japan and the US. Moreover, there is confusion about what is defined as 'research' and thus needs to be paid for, and what can be classed as a minor non-monetary benefit and thus be accepted free of charge (especially for fixed-income markets). There are also concerns about the coverage and liquidity of the small and mid-cap companies, which could lead to an increase in the capital costs of such companies and their ability to raise capital or list on the market, as market players withdraw from the market or shrink their teams.

Nevertheless, careful management of research expenditure can allow firms to bring down the costs passed on to clients and therefore pay themselves for external research for clients affected by MiFID II, rather than pass through the cost via the use of PRA. The RPA appears to be a cumbersome operational structure that restricts the ability to optimise the use of procured research across the investment teams to the benefit of clients. Schroders support the clarity and transparency that MiFID II introduces, and has been implementing the main tenets of the inducement rules of MiFID II for many years, having unbundled in 2006, put research budgets in place in 2014, and paid directly for corporate access since 2015.

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