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MiFID II and intended consequences

The next 15 months will see a tremendous amount of preparation for the implementation of the MiFID II Directive, due to be implemented in January 2018

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A key issue of the Directive requires investment research fees to be unbundled from trade commissions and paid for separately. Whether the buy-side chooses to use a Research Payment Account (RPA), a pre-agreed Research Budget or to pay for research from their own resources, an important underlying issue to be debated between the buy-side and sell-side is, "What is the value of the research we receive/provide?"

Approximately 50% of European buy-side investment managers currently pay for research with bundled commissions. As such, these managers have never really put an explicit price on research vs. execution. The 50% of managers that have used Commission Sharing Agreements (CSA's) have at least taken the first steps into quantifying the value of the research they receive. However, MiFID II challenges the use of CSA's as payment for research where it is still tied to the volume of transactions.

We believe that MiFID II will cause a seismic shift in how business is conducted between brokers and investment managers. Unbundling will cause full service brokers to dramatically change their business models and cost structures, especially if the investment management community values research at a lower price point than the brokerage community values its service.

Effect on buy and sell-side relationships

As clients, asset managers have often been seen as being in a strong position relative to the sell-side. Research has been assumed to have value, albeit never really quantified, and has been packaged with trading to generate a total variable annual cost tied to how much an investment manager happens to trade in a given year. The effect of the MiFID II separation of research services and trading will be greater scrutiny in the relationship between brokers and asset managers.

By providing greater transparency into the relationship between asset managers and brokers, investment managers ultimate end clients will have greater insight into how their money is being invested and spent. The regime for measuring the research spend will be very granular, and in many cases the amount paid for research will be pre-agreed between investment managers and their clients.

As a practical matter, asset managers must have written policies regarding investment research as well as annual budgets for each research provider. They will pay for research: directly (affecting the P&L); as a charge against a RPA funded by the manager in advance; or as a charge alongside a transaction commission to fund the RPA. In each of these schemes, specific charges must be taken into account.

Much remains to be decided apart from compliance with the administrative matters. For asset managers the research budget will be a new internal process. The RPA mechanism will also need to be managed either in-house or outsourced. Broker votes will also be affected. Despite representations in the past that broker lists would be reviewed, much remained the same.

For the sell-side, the allocation of internal resources to investment manager clients will become a significant issue. Will the coverage mix be affected as research pricing comes into effect? How will trade execution be priced?

Migration of MiFID and impact on execution strategy

The effects of MiFID II will likely expand globally. Since it has been issued as a "Directive," each affected country can have its own interpretation and nuance. France and the UK have each weighed in and there are some differences in their rules. Firms will have to comply separately with each. Even within jurisdictions, definitions will vary. In France, certain types of corporate access will come under the rules, while others will not rise to the level of "research".

As a practical matter, many global asset managers have already begun to migrate to MiFID II-like structures for internal efficiency. This begs the question of whether regulatory harmonization will eventually apply between the US and Europe. While FINRA and the SEC have not formally considered the regime to date, it may become part of the US conversation.

Many believe that bundling the payment for execution and research together devalued quality execution, as full service brokerage firms focused far more on the research side of the equation. Bundled commissions were also often at odds with investment managers' best execution obligations.

As firms wrestle with the value of research and the cumbersome administrative difficulties, one option is to rely on firms which solely offer trading and executions services at a known price. ■