MiFID II, Research Unbundling, and What it Means for You

Proposals to unbundle payments for investment research from trading commissions are a key part of the European Union’s updated Markets in Financial Instruments Directive (MiFID II). By forcing brokers to price and charge for services separately, the aim is to enhance transparency and accountability, and achieve both best execution and best research. European investment managers will be required to implement the changes on a global basis when they take effect in January 2017.

How will research be paid for under MiFID II?

Commission Sharing Arrangements (CSAs), are widely used at present, and enable buy-side firms to access best-of-breed research and execution from separate providers without incurring additional costs. However, under the proposed rules, European-based asset managers must set their research budgets in advance. The budgets can then be financed in one of two ways:

1. Asset managers that can use client money to pay for research must operate a Research Payment Account (RPA). For hedge funds and long-only asset managers, RPAs are funded as client expense items through their administrator or prime broker.

2. Firms that cannot use client money must pay for research directly or fund the RPA themselves.

The uncertainty surrounding RPA funding stems from regulators’ differing interpretations of the European Securities and Markets Authority’s (ESMA) December 2014 technical advice, which states that research payments should not be linked to the volume or value of execution services provided. In its February Feedback Statement (FS 15-01), the UK’s Financial Conduct Authority (FCA) maintained that CSAs are linked to transacted volumes and thus not allowed. Other European regulators argue CSAs will still be valid. Further clarity should be available soon, with the delegated acts expected to be published in September.
**Will research unbundling rules vary across Europe?**

Much depends on whether the final rules are implemented as a regulation or directive. If enacted as a regulation, they must be implemented uniformly across Europe. With a directive, local policymakers and regulators have more flexibility in how they interpret and apply the rules.

---

**How will the new rules affect sell-side research pricing?**

Under the proposed rules, buy-side firms will have to justify their choice of research services and demonstrate the value it provides. As a result, the price and underlying value of the research will be subject to much closer scrutiny. This means providers will have to quote a hard price for their research, and make their pricing structures transparent.

A major challenge for sell-side providers will be how to value their research. The value a customer derives depends on multiple, often user-specific factors, making it difficult to measure and price objectively.

---

**Furthermore, since MiFID II extends the rules to all asset classes, not just equities, it raises the issue of cross-asset class research consumption. How should research providers charge for that consumption?**

In addition, research costs typically have been embedded into the bid/offer spreads on fixed income products. When unbundling research, sell-side firms will have to determine what price to charge for that component and how it will impact on spreads.

With a move to explicit pricing, and as asset managers potentially become more selective about what they buy, there are also concerns that the quality and scope of research will decrease. This could result in less efficient capital allocation and reduced liquidity for certain securities, especially those of smaller cap and thinly-traded companies.

---

**What impact will research unbundling have on the sell-side?**

The impact will depend to a large extent on:

1. **Size of the firm:**
   - Bulge bracket firms will face the expense of providing research which may lead to a reduction or cessation of coverage on smaller companies/unattractive sectors. As research quality comes under increased scrutiny, widely-distributed generic research will also be considered of lesser value. Therefore, bulge brackets will need to focus on differentiating their research offerings.
   - Mid-tier brokers could benefit from opportunities to provide high quality research and execution services, for example on small or midsized companies if bulge bracket competitors withdraw from such areas. Success will depend on focus and expertise, and the ability to differentiate their research and execution capabilities from bulge bracket and smaller brokers.
   - Small brokers are likely to struggle unless they are/become high quality sector specialists or bespoke research providers. On the execution side, opportunities to add value may lie in offering very local block liquidity or finding liquidity for small/micro cap and illiquid names. Such niche players could prosper.
2. Market(s) where they operate:
The degree to which research and execution is currently bundled, and how widespread CSA use has become, varies from market to market. For example, Sweden implemented unbundling rules in January this year. By contrast, services in southern European countries such as Spain and Italy remain extremely bundled, so the impending changes will have a profound impact on market practices. Therefore, a local Spanish broker is likely to feel the changes more than a bulge bracket firm in the UK.

Sell-side firms could also face greater competition from independent research providers, which may see increased opportunities as asset managers reformulate their research purchasing decisions.

If CSAs remain eligible under the new rules, how will buy-side firms be affected?
The implications again will vary according to the firm’s size and location.

If the cost of research goes up, and it is not subsidised in their favour, smaller asset managers may be disadvantaged, given the relative impact any expense increase would have. The administrative burden of setting a research budget and measuring the value obtained will also be relatively onerous. Larger players with bigger budgets will have more capacity to absorb any extra research costs.

Markets that remain more bundled will experience additional impacts. For example, the introduction of unbundling will see trading desks gain greater discretion over where to route orders – although it may take some time for this change in approach and mentality to gain ground. As a result, the quality of algo and electronic trading will become more important. Likewise, trading desks will have to review the tools they have available to ensure they achieve best execution.

Since MiFID II encompasses all asset classes, questions also remain over how firms should allocate research payments. For example, can a global portfolio manager who consumes research for different asset classes share it with an equity-focused colleague? How should they pay for that?

Unbundling has VAT implications in Europe as well. Firms will need to determine how unbundling will affect the potential added costs of VAT on research.

What steps should buy-side firms take to prepare for the new environment?
Although we don’t yet have all the details confirmed, MiFID II will reshape market practices in Europe and asset managers can begin to prepare themselves now:

1. Start unbundling your broker relationships to gain transparency between execution and research. A CSA can help manage this process.
2. Review and compare past research budgets with future expectations.
3. Assess research consumption—are portfolio managers consuming every piece of research they receive? Are they receiving custom research?
4. Don’t unwind CSAs yet—wait for clarity on how the RPAs can be funded.
5. Once the proposals are finalised, revisit—and where necessary amend—the terms of existing CSAs.

6. Be able to show clients what portion of commission or dollars and expenses were allotted to them.

If CSAs continue to play a role, then the use of aggregators is likely to increase since it will be more difficult for asset managers to compile the increased amount of information needed from multiple CSA brokers. A CSA aggregator helps by consolidating commission credits, research payments and trade history from multiple CSA agreements into one central account. However, because you are relying on one firm, it is vital to ensure it is an expert in the field, with a full product offering and global regulatory experience. They should have a global commission management team with regional specialists who can provide local knowledge and service.

---

**If CSAs are abolished under the new rules, what changes will I need to make?**

Currently, CSA money is held with the broker [which will need to be in a ring-fenced account in the future]. But if CSAs are abolished, the way the RPA is operated would be very different. This raises important questions, such as:

- Where will the money be held?
- How will it be protected?
- How would you administer that account? Could you use your custodians to fund the RPA, with a third party [similar to a CSA aggregator] employed to manage the money from a centralised account?
- Can you use your current CSA broker to manage an RPA account?

---

**I am a non-European asset manager. What impact will the rule changes have on me?**

Asset managers in Asia and North America with only regional clients will not be affected by MiFID II. However, a firm must comply with EU rules when trading with a European trading desk and/or European investors. Where this is the case, key issues to consider include:

- Should I segregate the accounts of EU clients from those of my North America and Asia clients?
- Will I have to set-up separate regional CSA buckets?
- How do I avoid cross-subsidisation, to ensure non-EU clients are not paying for research used by everybody else?

In particular, the onus is on clearly disclosing to clients how you intend to pay for services and how you will use their commission dollars.
What else should I be aware of?

The separation of functions under the new rules means firms will have to evaluate their brokers both for execution and research. Best execution will be a primary concern, so transaction cost analysis (TCA) will become even more important.

For the buy-side it is vital they have the tools and information to make those TCA assessments. Meanwhile, sell-side firms need to ensure they can demonstrate they provide best execution.

For more information, or to discuss any of the issues raised above please contact info@itg.com or visit commissionmanagement.itg.com