Verus

Why MiFID II matters to U.S. investors

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Executive Summary

The deadline for investment managers to comply with the European Markets in Financial Instruments Directive (MiFID) II is quickly approaching. It is important for plan sponsors to understand the ramifications of the soft dollar regulation embedded in the directive, and how these new rules might affect plan participants. Some key points that investors should be aware of include:

- *Despite MiFID II being a European regulation, many U.S. domiciled investors will also be affected by the soft dollar regulation and, consequently, many U.S. domiciled investment managers are revising the way that they address execution costs.*
- *The intent of the soft dollar portion of the directive is to empower investors by providing them more transparency around commissions by separating execution costs from what is currently considered the implied cost of research.*
- *While this directive will better equip investors to assess best execution costs and the value of external research, many in the investment community are concerned that the separation of research from execution costs will dramatically increase the cost of external research and ultimately result in increased costs to clients.*

How investment managers address the additional soft dollar requirements will depend on the circumstances of each firm and product; however, in this paper, we attempt to identify trends based on the results of a proprietary survey we conducted.

Introduction

The Dalai Lama once stated that "a lack of transparency results in distrust and a deep sense of insecurity." This is undoubtedly true in the investment industry and is a key issue that the European Commission attempts to address with the Markets in Financial Instruments Directive II (MiFID II).

On January 3rd, 2018 MiFID II will go into effect in Europe. The purpose of this paper is to provide an introduction to the directive and to examine the expected costs of complying with the soft dollar standards which it introduces. This new approach to the use of client commission requires investment managers to separate the cost of research from execution services explicitly. It is important to note that the intent is more about direct recognition of costs that are already being paid by the client, and a change in the way those payments are made, rather than being a major increase in the cost expected to be borne by the client. However; the true costs to investment managers and clients will be contingent on the price set for research. Additionally, depending on how the investment manager addresses the soft dollar requirements, they may incur increased reporting costs.

Any well diversified institutional plan should expect at least one of the investment strategies in their portfolio to be affected by the soft dollar directive. Although investment managers will do their best to mitigate the cost of research by reducing the amount of external research received, it will be difficult for managers that do not already have a well-established research team to eliminate these costs. This may pose a challenge, at the margin, for the business model of smaller investment managers, or for those who were extensive users of the more specialist elements of the research services provided by brokers.

We anticipate that the soft dollar regulation will have a larger cost impact on active, rather than passive managers since active managers are more frequent users of third-party research. With profitability in the active management space already under pressure as assets trend toward passive management, plan sponsors should anticipate more directly subsidizing some of the costs of research.

While the directive itself comes from the European regulatory environment, and the Securities Exchange Commission offered some relief for U.S. domiciled brokers, given financial market globalization, ramifications of the directive will undoubtedly trickle into other markets.

What is MiFID II?

MiFID II is a byproduct of the original MiFID which was implemented in 2007 to standardize investment services regulation for members of the European Economic Area Agreement. This includes Norway, Iceland, Liechtenstein and all members of the European Union. Its expressed purpose was to strengthen financial stability and to encourage competition by removing financial barriers between countries. The initial directive promoted significant changes in market structure and some improvement in competition, the results of which led

to the perception of a need for additional regulation around transparency. This prompted the development of MiFID II, which represents both an attempt to respond to some of the perceived negative consequences of the initial MiFID, and an attempt to drive further change in the market for financial services. The primary goal of MiFID II is to empower investment service consumers by increasing transparency to enable more informed decision making.

All countries that are in the European Union on January 3rd, 2018, and the three countries noted above, must comply with MiFID II. Thus, despite the Brexit vote results, U.K. domiciled firms will need to comply with the regulation.

What restrictions are placed on soft dollar research?

Given the broad scope of the directive, this paper will focus only on the restrictions placed on soft dollar usage and its implications for investment managers' treatment of sell-side research. In addition to European domiciled managers, this change is expected to directly affect U.S. domiciled managers with significant European trading activity, European operations or European clients. In late October 2017, the Securities and Exchange Commission offered a 30-month relief period for U.S. brokers which allows them to sell research to European firms without registering as investment advisors. This means that U.S. domiciled domestic equity strategies that use U.S. domiciled brokers only, and have no European domiciled clients, will likely be unaffected by the soft dollar regulation. While the ramifications of the directive are still evolving, we can provide some initial indications of the likely implications, costs and challenges of compliance.

Managers have been keenly focused on Article 13 of MiFID II which states "member states shall ensure that the provision of research by third parties to investment firms providing portfolio management or other investment or ancillary services to clients shall not be regarded as an inducement..."[1] In short, Article 13 will restrict the use of soft dollar arrangements, a practice which is common among U.S. asset managers. Soft dollar (or soft commission) practices, as defined by the CFA Institute, involve using client brokerage commissions to purchase research that helps managers make investment decisions. To comply with this regulation, asset managers can either fund research from their own accounts, or create a separate research payment account (RPA) which is funded by the client. The directive provides extensive guidance on the second option including a requirement that managers provide research payment details such as the amount paid, the service provider's name, and the research type when requested by the client. It will be relatively more difficult for fixed income managers to disentangle soft dollar costs because unlike the equity market which has explicit commission costs, in the fixed income market all costs are bundled in the bid-ask spread.

What are the expected costs?

Whether an asset manager chooses to fund research from their own account, or create a separate research payment account (RPA), clients should see a reduction in what was

previously considered execution fees. For managers using an RPA account, this reduction will be at least offset with a research expense line item.

There has been a wide disparity in estimates for the cost of an annual subscription to a bank's research platform. Initial indications range from $10,000 for access to a low-cost provider, to $1 million for access to a top-rated research platform.[2] To illustrate the effect this expense could have on a manager's bottom line, we apply a hypothetical assumption that annual costs are $100,000. Ignoring any reduction in transaction costs, if a manager's fees are 60 bps, the cost the manager would have to pay for the research they currently consume would be the revenue equivalent of a $17 million account. There is no question that these fees will affect smaller, boutique investment firms more than larger ones if the manager chooses to finance the research independently. Conversely, explicitly passing the cost on to the client will distribute the burden among clients and lessen the financial burden on an individual firm, but this option creates additional tracking and reporting costs for the asset manager. In addition to passing along reduced execution fees to the client, firms that choose to take on the cost of research would avoid the complexity of dividing these fees among clients and incurring additional reporting fees but clients would forfeit transparency into fees paid by the manager. One U.K. manager we spoke with described the final decision as a commercial one, implying that even if the asset manager takes on the costs, they are likely to pass them on to the client through increased management fees.

As managers prepare for MiFID II, many are considering ways to reduce their research expense. Based on our survey of 165 investment teams, nearly all of the managers who believe they will be affected by the directive are reviewing current research sources to identify and eliminate less used material. After the manager has identified heavily used research, the firm will then need to consider how much they are willing to pay to retain these services. To further delay this analysis, brokers have been reluctant to be the first to put a price on their research. Since investment managers must set an annual research budget at the start of the year, brokers are aware of their inability to benefit from price discovery during the year. This could be a problem for asset managers as they try to estimate the cost of becoming compliant before year end. On a positive note, one manager we spoke with expects these costs to decline over the first two years after the directive goes into effect as the industry evolves and more boutique research-only firms enter the market.

In addition to managers examining areas of potential cost reduction, MiFID II will provide consumers of those services the ability to scrutinize research and transaction costs more effectively and determine the marginal benefit of each additional unit of research. During this analysis, it is important for clients to consider differences in research quality and the missed opportunity costs that could arise when the breadth of research sources is reduced.

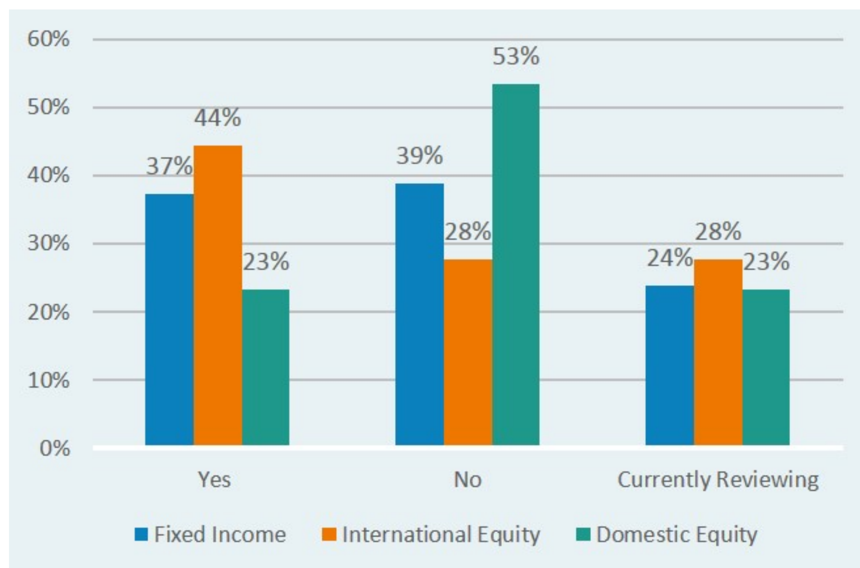
U.K. asset managers could provide a template for U.S. managers since many of these firms started the soft dollar unbundling process years ago as a result of changes initiated by the domestic regulator in 2004, with further change driven by the original MiFID recommendation. To further support the transition, the Investment Association in Europe

provided an Enhanced Disclosure report as a guide to separate execution and research costs. MiFID II further isolates execution from research costs by requiring separate contracts for each service. U.K. managers are expecting the Investment Association to provide a similar reporting guide for MiFID II compliance.

What are investment managers saying?

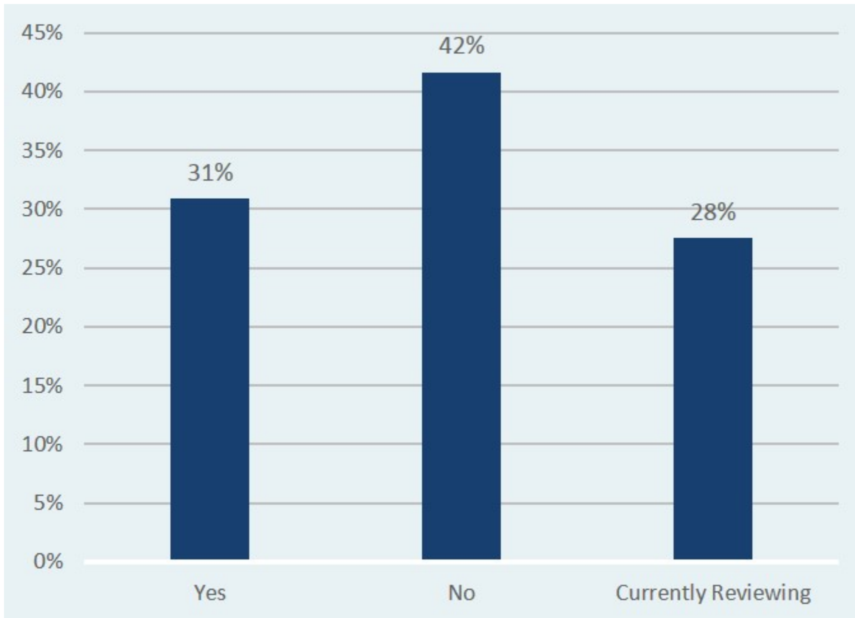
We surveyed investment managers, at the product level, across international, domestic and fixed income strategies to determine if they expect MiFID II to affect their research or execution process. The 164 replies indicate a wide disparity in managers' understanding of the impact of the directive. The results, compiled below, show that most international equity managers are anticipating some impact from MiFID II while a high percentage of domestic equity managers do not expect to be affected. Feedback from fixed income managers was fairly evenly distributed.

WILL THERE BE ANY CHANGES TO YOUR RESEARCH AND EXECUTION PROCESS AS A RESULT OF MIFID II?



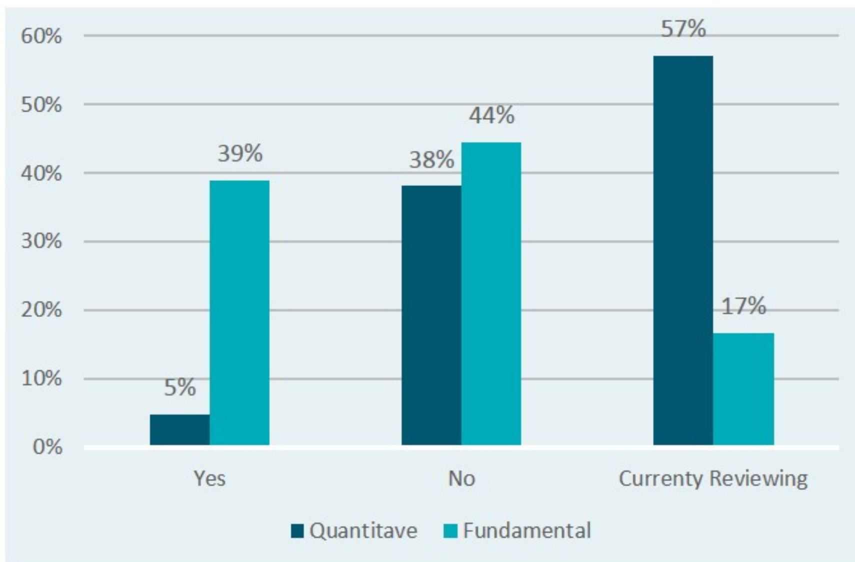
Although the Securities and Exchange Commission offered a 30-month relief period for U.S. brokers, 30% of the U.S.-domiciled, domestic equity teams that we surveyed are reviewing their research practices as a result of MiFID II.

U.S. STRATEGIES RESPONSE PERCENTAGES



As it relates to strategies that invest in non-U.S. assets, over 50% of these U.S. domiciled quantitative managers responded as “currently reviewing” the requirements; while less than 20% of fundamental managers are still reviewing. This may be an indication that U.S. domiciled fundamental managers are further along in the assessment process than their quantitative counterparts.

RESPONSE PERCENTAGES BY INVESTMENT STYLE



Conclusion

As the ramifications of the soft dollar directive continue to evolve due to conflicting regulatory regimes, interpretation uncertainty, and competitive pressures, very few non-European investment managers have developed a conclusive plan of action to address the requirements. Despite this, clients should be prepared to possibly subsidize some of the costs of research. This may be a direct charge via a Research Payment Account, or an indirect payment via increased management fees. If the investment manager uses a Research Payment Account, clients will be required to approve research fees and should expect paperwork from the manager describing the procurement policy and research rates near the start of the year.

As one manager explained, the decision on how research is funded going forward will be a commercial one. Logically, boutique investment managers may not have the capacity to take on the cost alone. Additionally, these smaller managers are likely less equipped to take on research in-house. This means plan sponsors with significant exposure to boutique international strategies may have to consider the appropriate level of total asset management fee (including research expense) to ensure that their managers are able to research their markets effectively.

Verus will continue to track how managers are incorporating this directive as it evolves, but clients should expect the ambiguity to decline as the January 3rd, 2018 deadline approaches.

Appendix

Surveys were sent out regarding 285 investment strategies. Of those, 164 managers replied. Below is a breakout of the distribution and response details.

Manager Type	Surveys Sent	Responses
Fixed Income	115	67
International Equity	92	54
Domestic Equity	78	43
Total	285	164

Manager Style*	Surveys Sent	Responses
Quantitative (U.S.)	35	21
Fundamental (U.S.)	147	89

Manager Domicile	Surveys Sent	Responses
US Domiciled	258	147
Non-U.S. Domiciled	27	17

** Only U.S. domiciled firms counted under manager style.*

Notes & Disclosures

1. *http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf*

2. *https://www.ft.com/content/8dcec858-6c5f-11e7-b9c7-15af748b60d0*

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