
# MiFID II: The Price of Investment Research

MiFID II's sweeping reforms are set to transform the investment research industry, with the impact to be felt far beyond the European Union.

*New rules under MiFID II are set to put a price on investment research, which will boost competition and quality, but fund managers may be reluctant to pay when presented with the bill.*

## Research unbundled

Traditionally, asset managers received research bundled with trading services, but under MiFID II, which comes into force on January 3, 2018, research activities will be bought and sold as distinct services. This 'unbundling' is intended to boost transparency, reduce costs and prevent conflicts of interest that may arise from linking research to trading commissions. While welcomed by investors, the new regime introduces pricing complications for the global investment research industry.

## Passing the investment buck

The new rules will compel asset managers to either make direct payments to research providers from their own accounts or charge end-investors through separate accounts, meaning a trade-off between leaner profit margins or further operational burden.

Large investment firms will be better placed to absorb the costs of research, but smaller firms that operate with lower profit margins may ultimately pass the costs on to investors through higher fees.[1] The alternative approach involves a more complex mechanism, requiring fund managers to set up ring-fenced research payment accounts (RPAs). The RPAs are governed by Commission Sharing Agreements (CSAs) detailing the split between research and execution costs, and how commissions are shared between research providers. However, the strict budgetary and disclosure regime demanded by RPAs may, prove too burdensome for firms who would need to take on additional compliance risk.[2]

## Paying the price

Determining a price for research has long been complicated by its bundling with execution costs, and especially so for fixed income markets, where costs are typically embedded in spreads.[3] With the cost of an analyst's time and work set to become more explicit, setting competitive pricing will become a core concern for sell-side brokers and independent research firms. The unsophisticated research will struggle to find buyers. But, fund managers seeking access to top quality research from "star" analysts can expect to pay a premium. Some sell-side research firms have quoted fund managers up to USD 150,000 to access analyst reports and basic services.[4] Many buy-side firms have announced they

## KEY INSIGHTS

- More fund managers are opting to absorb costs of research, rather than passing them on to clients
- US firms face a regulatory dilemma in selling research in the EU
- Boutique and specialist research firms are expected to prosper

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will absorb these costs rather than pass them onto investors through higher fees. US fund manager Vanguard, which has USD 4.4 trillion under management, announced it will stop charging investors for research, joining a number of prominent Europe-domiciled funds, including Aberdeen Asset Management and M&G, in absorbing the cost.[5] The Financial Times, which maintains a running list of asset managers opting to pay for research, has identified 60 firms that plan to absorb costs. The number of firms considering passing costs on to clients and those still undecided, is significantly lower and sits at 13.[6] "In general, there is an expectation among investors that asset managers should be paying for research themselves,"[7] said Benjamin Quinlan, founder of Hong Kong-based consultancy Quinlan Associates.

## Local action, global problem

Although the new regulations are targeted at EU asset managers and firms, the impacts are expected to be felt worldwide. Non-EU firms that distribute research to European clients will also be bound by the rules. US firms face a particular dilemma due to local rules that prevent the unbundling of research from execution charges.

They are banned from receiving direct payment for research unless registered as investment advisers, which would entail a greater compliance burden and oversight responsibilities.[8] US firms hope that the Securities and Exchange Commission will provide relief from this requirement, but it is unclear whether the regulator will act in time. The increased operational activities created by MiFID II in other jurisdictions could ultimately prompt regulators to introduce their own EU-compliant research rules, which would be welcomed by international fund managers reluctant to manage bifurcated payment models.[9]

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## Niche opportunities for boutique research firms

There is little doubt the research investment industry is poised for a shake-up. Firms that provide research for free with trading commissions often send their clients many reports, many of which may go unread. Better informed investors will be disinclined to pay for research they deem unnecessary. Asset managers are also expected to be more discriminating in their selection of research providers to demonstrate they are not being induced to trade.[10]

Larger sell-side research providers with top analysts and who reap significant revenues from commissions are seen as best-placed to weather the changes, along with fund managers with investment strategies that do not rely heavily on external research, such as passive or quantitative investing. Small to mid-tier research firms, may be more heavily impacted. Some analysts see a resulting reduction in quality research for small to mid-capital companies, which could reduce the liquidity in such markets and widen the spreads, against the intentions of the regulators.[11] However, the new rules are expected to drive increased specialization and competition from boutique and independent providers who can service niche demand for intelligence in a particular asset class, industry or country.[12]

The rules may hasten a contraction of the research industry in tandem with the rise in passive investing.[13] The decline in global research spend is set to continue and could fall by as much as 30 percent by 2020, Quinlan estimates.[14]

MiFID II reforms will pose significant challenges for an industry that has long sought to price research efficiently, but will also create opportunities for nimble firms capable of providing high quality, specialized research demanded by asset managers and investors.



1. Price Waterhouse Coopers (September 2016) The future of research 2. Bloomberg (September 19, 2016) MiFID II set to disrupt investment research worldwide 3. Ibid. 4. Ibid. 5. MoneyMarketing (August 7, 2017) Vanguard to absorb research costs under MiFID II 6. Financial Times (October 13, 2017) FT Series: Countdown to MiFID II 7. Ibid. 8. Thomson Reuters (April 22, 2017) U.S. firms in uncharted waters 9. Quinlan & Associates (August 2016) Research in an unbundled world 10. Ibid. The future of research 11. Ibid. MiFID II set to disrupt investment research worldwide 12. Ibid. Quinlan & Associates 13. The Economist (March 30, 2017) Banks' equity-research operations are in decline 14. Ibid. Quinlan & Associates



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