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MiFID II Research Budgets: The Client Frontier

Under MiFID II, asset managers need to begin the process of delivering MiFID II client research budgets in 2H 2017. Given the importance of this exercise, and the rapidly shrinking timeframe, asset managers need to be devising research budget policies and related client communication strategies now, as this has become a competitive issue that will soon outweigh the regulatory considerations.

MiFID II will require asset managers under its jurisdiction to furnish asset owners with ex-ante monetary research budgets for FY 2018 *that pertain to the specific investment products in which they are invested.*

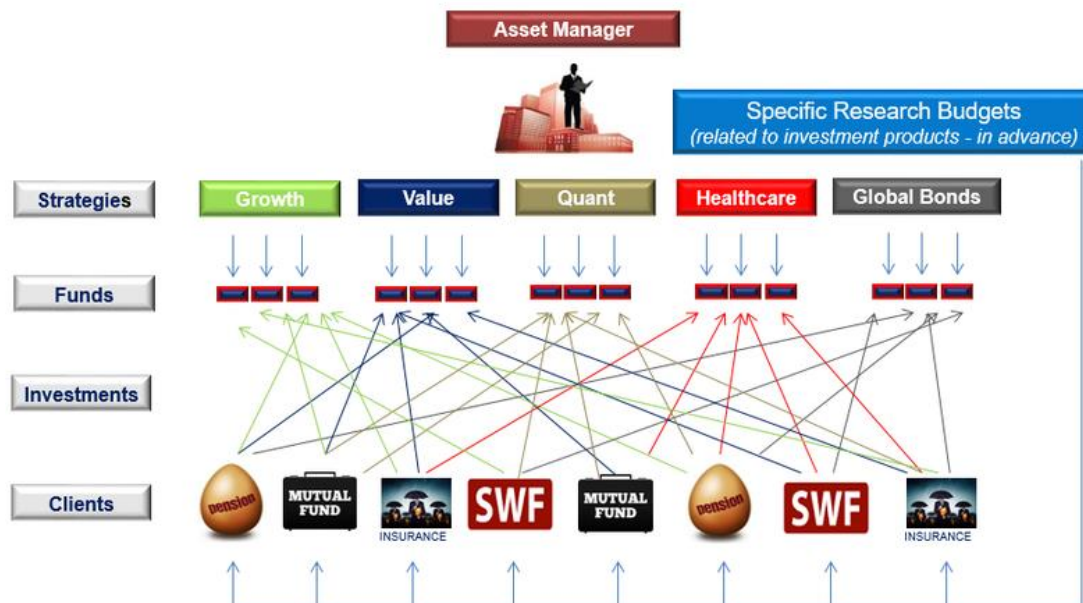
Many managers, who have understandably been concentrating on making the CSA/RPA mechanism work, may have failed to realize that they need to begin the process of delivering *MiFID II client research budgets in 2H 2017.*

Given the importance and sensitivity of this exercise, and the rapidly shrinking timeframe, the C-Suites at asset managers need to be devising research budget policies and related client communication strategies *now.*

MiFID II raises the bar substantially from current UK regulations that specify firm-wide, rather than client-specific, research budgets. This is a significant challenge for complex managers who will have to align hundreds of investment funds/products into strategy-level research budgets that will still allow for fair allocation of research costs to clients – on a multi-asset-class basis!

Managers have to inform clients of the *quantum* of their research spending in advance. *Ex-post* clients and regulators have the right to see research producers paid, specific products purchased, and how they were a) valued and b) created value for the portfolio.

This has the potential to substantially alter the asset manager-asset owner dynamic, not only in Europe, but globally.



Why US Managers Should Care About MiFID II Research Budgets

US-based global managers, with whom European asset managers compete, may send research budgets to *all clients*, including US asset owners. If US managers have European clients, those asset owners will be receiving research budgets from their European managers.

If the US clients of domestic managers also have European managers, those asset owners will likely receive research budgets.

A key impact of MiFID II is that it has permanently changed the research transparency expectations of European asset owners – who are important allocators on a *global basis*.

This has become a competitive issue which will soon outweigh the regulatory considerations.

The Impact on Asset Manager Profitability

For most active managers, the investment/research process is the vital DNA of the firm and is the key reason they are hired by asset owners.

The way research is funded has a significant impact on manager profitability. If asset owners were to refuse proposed MiFID II research budgets, and that research spending moved to the P&L of the manager, the profitability of active strategies could fall by 30%-60%.

Moreover, several large UK managers have announced that they will pay for research via their own P&L and presumably will present this as a competitive advantage.

The vast majority of managers will have little choice but to continue to use commissions for research. They will have to justify this. Managers are now coming to the realization that the decision over using client funds for research does not lie in their hands alone. The people whose money it is also have a say.

The Responsibilities of US Pension Trustees

The moment that a US pension fund is notified by a manager that a specific amount will be taken out of its account to fund research, it generates an immediate fiduciary responsibility for the pension trustee. They then have to consider if the budget request is reasonable.

The stakes are high for asset managers, particularly relating to this initial set of research budgets. This has never happened before. It is unclear how asset owners are going to react to widely varying research budget proposals from managers running very similar mandates. If an asset owner rejects the initial research budget proposal from a manager, what are the implications for the relationship?

Furthermore, asset managers will have little idea of how competitors will be preparing their research budgets in terms of the level of aggregation and/or quantum of spending.

Key Questions Asset Managers Need to Ask Themselves

- Do you know how your aggregate, firm-wide research spend compares to competitors?
- Have you assigned funds products to strategy budgets?
- Have you considered the varying “research intensity” of strategy budgets? Some use more research than others, which should be reflected in the budgets.
- Can your existing “broker-vote” system break down specific research charges on a per-client basis (related to the investment products they own) and eliminate fund cross-subsidization by fairly charging clients for research used by multiple funds?
- Can your firm do all of the above on a multi-asset-class basis?

The Future Is Now

These are complex questions – but they need to be addressed quickly. Many asset managers have delegated MiFID II-related tasks to mid-level operating committees whose purview is presumably not to make major strategic policy decisions for the firm – decisions which will have a major impact on the company’s profitability and competitive positioning with asset owners.

The UK FCA plans further guidance in March on the types of research valuation processes it expects to see enacted to replace the “broker-vote.”

Asset managers have a binary choice:

1. “Fight the Tape” – attempting to fit a round peg into a square hole by trying to modify an existing firm-wide equity broker-vote process to create client-level research spending reporting on a multi-asset-class basis (if possible).
2. “Get Ahead of the Curve” – by creating strategy budgets that reflect the actual investment process and fund strategy that the asset owner purchased in the first place.

Will clients/regulators/consultants notice the difference between these two approaches? We’ll find out ... beginning in 2H 2017.

The likely key to securing asset owner approval is the ability to demonstrate how the client’s research spending directly supports the investment process and client return objectives mutually agreed when the investment was made.