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MIFID II: AN UPDATE

The January 3, 2018 deadline for MiFID II compliance is fast approaching and this is commanding an increasing amount of attention from the asset management community as they adapt their business functions to comply with the requirements.

Many of the questions outlined in our original paper, "5 Questions to Ask Your Asset Manager About MiFID II" have now been answered at a high level but there remain some areas of detail still to be resolved. This follow-up paper aims to provide an overview of where the asset management industry stands on MiFID II and what we, within Manager Research, are doing to engage with managers on the topic.

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RESEARCH UNBUNDLING

One aspect of the regulation that has received significant attention has been research unbundling – the requirement for European based investment managers to separate their payments for execution and research, i.e. pay 'hard dollars' for research they choose to buy. This requirement gives asset managers the choice to either cover the costs of that research themselves or charge it to their portfolios and thus clients.

Mercer's position on this has been clear; we believe investment managers should cover the cost of research themselves. This would mean that the management fee is a more explicit reflection of the cost of managing the portfolio, which in turn would enhance transparency and enable clients to make more informed decisions when investing. Anecdotal evidence suggests the cost of external research can be up to 5 basis points depending on the size of the manager and the nature of the approach.

We welcome the fact that over 92% of assets managers surveyed by the Financial Times[1] that are covered by MiFID II have elected to pay for research themselves; i.e. from their own P&L. In our view, this marks a positive step for the asset management industry.

We do note that there are a number of implications, intended and potentially unintended, of these changes. We believe three of the most notable are as follows:

1. GLOBAL IMPLICATIONS

MiFID II is an EU directive and, as such, only directly applies to firms undertaking investment activities within the EU. However, financial markets, and the firms that operate within them, are often, by their very nature, global, meaning the consequences of this regulation are far wider-reaching than just Europe.

On this point there has been much written about a conflict in regulation between MiFID II requirements and existing SEC regulations in relation to unbundling research costs. In the U.S., the SEC requires brokers that sell stand-alone research (i.e. unbundled) to register as "investment advisers." This is seen as an onerous process and most U.S. brokers avoid doing so by bundling their research and execution services. This creates difficulties for US brokers in selling unbundled research to asset managers based in the EU.

On October 26, 2017 the SEC issued a temporary 30 month no-action letter which promises not to prosecute US brokers who sell unbundled research to MiFID-affected asset managers without being registered as an investment advisor. This ensures that EU based asset managers can continue to access US sell-side research in the near term during which period the SEC plans to review longer-term solutions to the conflicting regulatory systems. This is likely to have implications for asset managers, particularly those who operate with investment teams spread across multiple regulatory regimes, given that outside of the EU, bundled practices remain the norm for asset managers. This creates questions for global asset management firms about the practicalities of operating with investment teams spread across multiple regions using a mixture of bundled and unbundled practices. Managers should have plans in place to ensure clients, regardless of domicile, are treated in a fair and transparent manner.

[1] *The definitive list of asset managers that will pay for research. Financial Times. 26 October 2017.*

2. IMPACT ON THE SELL-SIDE RESEARCH MARKET

Asset managers and sell-side brokers have been locked in negotiations over the cost of research for several months as they seek to establish an efficient market structure for purchasing sell-side research. Most anticipate that the sell-side research market (brokers) will shrink as much of the perceived low value research, that had been subsidised by the bundled commission structure, will no longer be paid for. We would expect that over the long-term this will lead to a leaner research market where the research produced has genuine value to those consuming it. This seems a positive outcome for clients, especially given that, for many years, the majority of asset managers have informed us that much of the sell-side output offers little value.

There are various arrangements that can be agreed between asset managers and brokers for research services. These include blanket research coverage (low cost access to a brokers' 'off-the-shelf' research platform), pay as you use (an ex-post payment system tied to the research consumed) and bespoke research (tailored research/calls with analysts on specific topics). Managers should be able to explain to clients how, under the new unbundled regime, they ensure they are able to retain access to quality external research which they require.

3. IMPACT ON SMALL ASSET MANAGEMENT FIRMS

As is the case in any industry, there are commercial advantages in having scale within asset management and MiFID II could prove a larger burden for smaller boutique houses than larger firms. We note that despite this, the majority of boutiques that we engage with have elected to cover the cost of research themselves.

Our approach towards evaluating managers is the same regardless of their size and it is beholden on all firms (large and small) to demonstrate their ability to build robust investment processes which can deliver repeatable outperformance while also being transparent about the costs of doing so.

WHAT WE ARE DOING WITHIN MANAGER RESEARCH

Within Manager Research we continue to actively engage with managers on MiFID II as part of our wider research process, where appropriate. This includes exploring the manager's approach towards sourcing and valuing sell-side research and, where relevant, managing effectively the consequences for their organization and clients globally. As stated in our original paper, where applicable, an asset managers' approach towards implementing MiFID II continues to feed into our broader assessment of firms' business management.

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