

FIVE QUESTIONS TO ASK YOUR ASSET MANAGER ABOUT MiFID II

The Markets in Financial Instruments Directive (MiFID) is the framework of European Union (EU) legislation for firms that provide services around and trade in financial instruments (shares, bonds, funds, etc.). It is legislation that asset managers (and other financial firms) need to comply with and therefore cannot be ignored by asset owners.

At the beginning of 2018, a swathe of new requirements will come into force across Europe as a result of MiFID II. The objective of MiFID II is to improve legislation in a number of areas, such as investor protection and transparency. It is a wide-ranging piece of legislation and potentially affects a large number of asset management functions – from trading, transaction reporting and client services to IT and HR systems. This paper focuses on a small number of areas that are seen as the most impactful, such as unbundling research costs from trading commissions and transaction reporting.

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1. ARE YOU READY?

One of the new requirements is an increase in the level of reporting for security transactions to regulators, aimed at ensuring managers achieve best execution. Asset managers will likely need to develop new systems or adapt existing ones to do this and make decisions as to whether this is done in-house or outsourced. Time is running out for those that have not already taken steps to address these requirements, and non-compliance will be subject to regulatory enforcement, which may include fines.

Overall, asset managers should have comprehensive plans for all aspects of MiFID II and be able to demonstrate that they can implement them by the deadline of January 3, 2018.



2. WHAT HAVE YOU DECIDED ON UNBUNDLING?

Many asset managers use research provided by third parties, including banks and brokers they execute trades with. An important requirement of MiFID II is that execution and research costs must be unbundled from commissions paid. “Soft commissions” in their current form, where asset managers pay a single commission for execution and get research “for free,” will cease to exist.

There is still much uncertainty about what brokers will charge for research and what is classified as research, but a key decision asset managers need to make is whether the cost of research is borne by their own business or passed on to their clients (see next question). If research costs are passed on to clients, and there are no offsetting reductions in other fees or execution costs, investors will, by definition, achieve lower net returns.

Asset managers should be able to explain how they have thought through the wider impact of unbundling on their investment processes. Because so much research has been available “for free,” previously little thought might have been put into what research was actually required to support the investment process. Asset managers should be able to demonstrate how they have reviewed their research requirements and assessed how important and valuable the existing flow of research has been to the investment process. They also should be able to describe how they are engaging and negotiating with third-party providers, such as banks and brokers, on this issue.



3. WHO WILL PAY FOR RESEARCH?

As previously noted, unbundling means that research will need to be paid for. Asset managers can choose to pay for this research themselves or charge their clients. If they charge their clients, a number of measures are aimed at making this transparent to the client and spreading the costs fairly. Mercer believes that asset management firms should pay the costs of research themselves. This will 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. If an asset manager chooses to charge its clients, the manager has an obligation to justify this decision and formally agree to the research budget with clients on an annual basis, which in itself is likely to be an onerous process.



4. HOW ARE YOU TREATING INVESTORS OUTSIDE THE EU?

Although MiFID II is an EU framework, many asset managers have non-EU clients and have investment offices outside the EU. This presents additional complications as to whether asset managers should implement unbundling across their whole organization or maintain bundled arrangements in non-EU regions. It also remains unclear at this stage whether other regulatory bodies will follow suit and enforce similar legislation to MiFID II. Your manager should be able to explain how MiFID II impacts its organization and clients globally.



5. HOW WILL I BE IMPACTED?

The European Commission states that “MiFID II aims at establishing a safer, sounder, more transparent and more responsible financial system that works for the economy and society as a whole.”¹ A number of the requirements are based at retail investors. But at a minimum, an investor in 2018, whether classed as professional or retail, should be no worse off than they are now, especially when it comes to the total fees and expenses being paid. You should also have improved protections by an increase in the amount of information that has to be provided to you both before you enter into a new investment and on an ongoing basis. Your asset manager should be able to demonstrate where the costs will be incurred and, ideally, also show how you might be better off – for example in terms of transparency and better execution. Your asset manager should be able to clearly articulate and defend any fees and costs that will increase as a result of MiFID II as well as show areas where costs might come down – for example, commission payments. This needs to include administrative and other costs that might creep in – for example, those associated with the increased reporting requirements. It should also be clear where costs will fall (for example, in the management fee or in other expenses) and how transaction costs will be reported.

CONCLUSION

MiFID has potentially far-reaching consequences, and asset managers should be well prepared for the changes. We believe the increased transparency under MiFID II will provide a wealth of valuable information for asset owners and shine the spotlight on costs and expenses that might currently be “hidden.” Overall, we believe asset managers should absorb their fair share of any net costs associated with MiFID II. In particular, we believe that asset management firms should pay the costs of research themselves.

¹ http://europa.eu/rapid/press-release_MEMO-14-305_en.htm



Unbundling research costs from trading commissions and transaction reporting are just two of the several MiFID II requirements coming into force in January 2018. Others include:

- Mandatory procedures for asset managers and intermediaries to ensure the suitability of the investment products/services delivered to the end client
- Stricter governance requirements regarding the distribution of financial products and effectively a ban on inducements for independent advisors
- Enhanced recordkeeping for telephonic and electronic-based communications relating to transactions concluded between investment professionals and clients
- The introduction of a new category of trading venue – the Organised Trading Facility – which aims to promote best execution and increased transparency for nonequity trading
- Stricter regulation on trading venues, including requirements for continuous, real-time price and volume quotes on securities

These requirements are likely to require some changes to asset manager’s operational and administrative infrastructure, and it is also worth discussing what steps it has taken to prepare for these requirements.

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