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The future of research

Impact of MiFID II on research for investment firms

MiFID II – Discussion paper

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Executive summary

As part of the investor protection framework within MiFID II, investment firms need to make explicit payments for investment research in order to demonstrate that they are not being induced to trade. Investment firms will need to have systems in place in order to manage unbundled payments for execution and advisory services, develop a taxonomy of services that are categorised as research and pricing models for these services.

This regulatory obligation will pose significant challenges for the industry as sell side firms must complete these activities and disclose the associated costs and charges to buy-side firms in order for them to demonstrate that they are acting in their best interests and have not been induced to trade.

However, it also presents significant opportunities as the production and dissemination of research services must now be considered a distinct revenue stream that can be sold to clients.

This paper sets out what the MiFID II requirements are, the challenges and practical implications associated with these, what this will mean for the industry, and lastly how firms can establish programmes and approaches such that they maximise any potential upside.

New requirements for research

MiFID II and what it means for research

MiFID II and MiFIR set out new requirements that continue to reform the EU securities and derivatives markets by further enhancing what was introduced under MiFID I in 2007. The legislation is due to go live in January 2018 and will introduce significant front to back changes for bond, stock, commodity, and derivative trading.

In addition to ensuring markets are operating in an orderly fashion, the new requirements seek to enhance both transparency and investor protection in order to protect end investors. As part of this new requirements are being introduced to mitigate conflicts of interest risks associated with research but also to ensure research isn't being offered as an inducement. The requirements fall on both buy and sell side investment firms and include:

- Sell side firms must not induce clients to trade by bundling research within their execution services.
- Sell side firms are required to review and identify services provided that could be categorised as research and therefore for which payment would be required.
- Sell side firms need to provide clients unbundled costs of trading, separately identifying and charging for execution, research and other advisory services.
- Buy side firms have to make explicit payments for research, and demonstrate that research contributes to better investment decisions and is therefore not an inducement.
- Investment firms need to provide better reporting to facilitate payments being made for research and to help demonstrate the value that research is providing.

We expect limited further guidance or detail will be offered by ESMA or local regulators on the new requirements for research prior to the national transpositions, due in March 2017. However, to meet the requirements by the MiFID II deadline of January 2018, both buy and sell side firms must begin to act now, perform their analysis using assumptions where there is uncertainty, and determine the most strategic and commercially viable means of operating in the post MiFID II era. As part of this, consideration should be given to touch points and dependencies with the other regulations being implemented across Europe (such as Market Abuse Regulation), and what enhancements need to be made to the control environment to support the decisions being made.

This paper highlights some of the key challenges that need further thought and potential outcomes for the industry as a consequence of the new requirements.

Challenges and practical implications

Defining which services should be categorised as research

MiFID II goes beyond the existing MiFID I or Conduct of Business (COBs) definition of Investment Research. It no longer just applies to independent investment research but it also applies to advisory services provided by Front Office Sales or Trading personnel. This extended definition includes:

- Materials or services that could inform an investment strategy, adding value to an investment decision, either explicitly or implicitly.
- Covers one or several financial instruments, issuers of financial instruments, assets or related market sectors.
- Provides a substantiated opinion as to the present or future value of the given asset, instrument or issuer.

Buy and sell side firms will now need to create frameworks to evaluate the myriad of materials and services they produce, distribute and consume to understand where on the spectrum it lies, and therefore whether it needs to be paid for.

Research — **Spectrum between 'Marketing' and 'Research'** — **Marketing**

Segregated research team	Desk-based research	Desk-based trade ideas	Commentary, morning notes	Advertising, marketing
• Behind 'barriers'. • Specific, conclusive trade ideas and commentary. • 'Substantive' (COBS 11.6.5).	• Not behind 'barriers'. • Conclusive trade ideas and commentary. • Not necessarily 'Substantive' (COBS 11.6.5).	• Ideas and commentary. • May be related to specific securities, sectors, industries, markets. • Distributed only to clients. • May contain a recommended action.	• Ideas and commentary. • May be related to specific securities, sectors, industries, markets ('colour'). • Distributed only to clients. • Generally not a recommendation for an action.	• Produced by marketing staff (with internal assistance). • Not a recommendation for an action. • Information generally for public consumption.

For some materials, firms may be able to demonstrate that they are of a minor non-monetary benefit and therefore exempt from the new requirements provided the service is not substantiated and nor does it contain any substantive analysis. However the majority of materials are unlikely to meet the criteria for the exemption and so will be defined as research meaning the investment firm will need to consider the impact on operating models, resourcing and pricing.

Classification is complicated further by the often unclear link between 'research' and the 'benefits' clients derive from such 'research'. Research producing firms must be prepared to judge this objectively going forward.

Paying for research

Historically when a buy side firm increased its trading volumes, it could pay more for receiving the same amount of research and would pass on these costs to its clients. With the new requirements buy side firms must not link the amount paid for research to the volume or value of transactions, instead they must agree a budget to be paid for research up front and pay an amount that correlates to the quality and value that it would provide to the end investor.

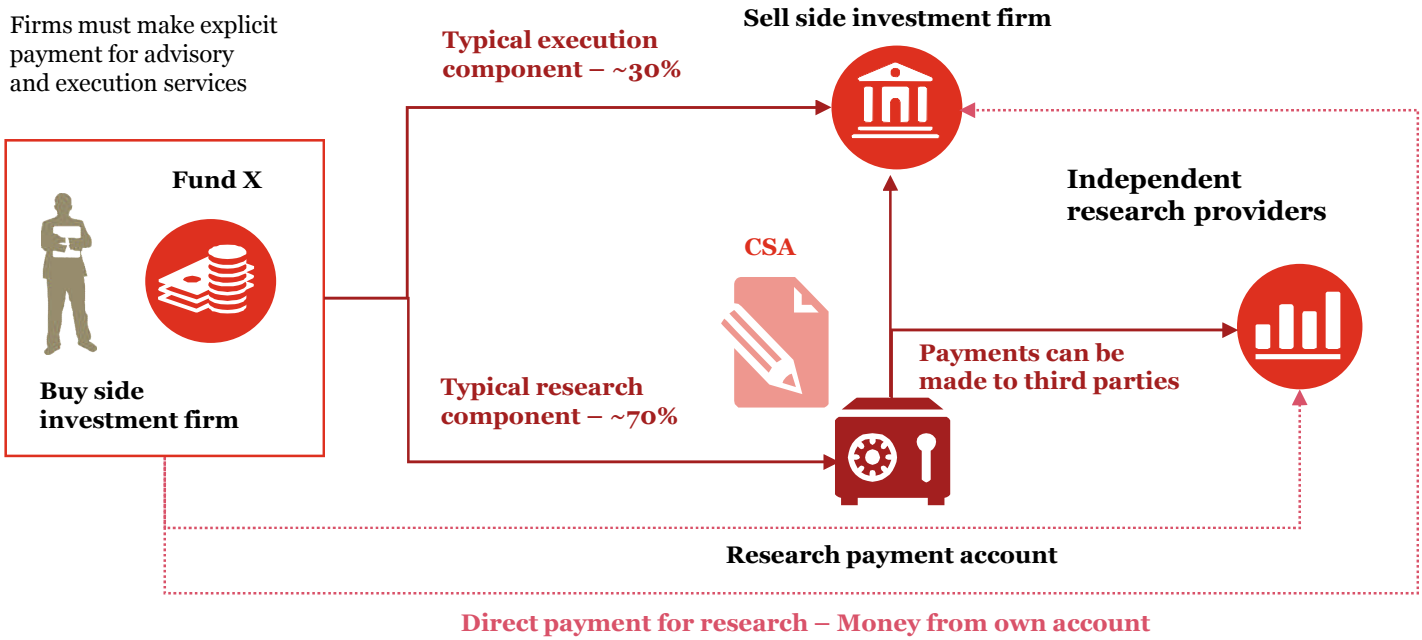
Buy side investment firms are able to make the choice of paying for investment research:

- Directly from their own account; or
- Should they choose to pay using client commissions, using a Research Payment Account (RPA) supported by a Commission Sharing Agreement (CSA), which codifies how execution costs are split into execution costs and research costs and how commissions are to be shared amongst research providers.

To support this sell side investment firms will need to unbundle their costs for research from the cost of execution, such that buy side firms can make explicit payments for research received. They will then need to be able to process direct payments or commission based payments and attribute those payments appropriately.

Regardless of the payment mechanism, sell side investment firms will need to manage payments from clients, funds within clients and other research providers. This model may need to be flexible such that it can be optimised to be able to deal with different regulatory environments.

Buy side firms will need to weigh up which of the options is more optimal. While paying directly may minimise the operational impact of the new requirements, profit margins will be impacted unless management fees can be increased. If management fees are maintained then, ceterus paribus, this may increase the attractiveness of the fund manager to its clients. On the other hand, if firms are seeking to recover costs using client commissions, there will be a need to introduce or enhance existing RPAs and CSAs. This will have a greater operational impact and will require change to existing processes. Whichever option is selected, firms will need to demonstrate that research obtained does represent value for money.



How do you price research?

Sell side firms and independent research providers need to assess how best to price research. They can consider a number of options each of which will have a different operational impact:

- Explicitly pricing into the bid offer spread or the commission the cost of providing research and charge until an agreed cap has been reached with each client.
- Charge clients a direct payment on a regular basis for advisory services which would include charges for research.
- Charging specific amounts for bespoke and specific pieces or research.

For cash equities, implementing changes is likely to be easier given the concept of unbundling is not new, but for fixed income and other non-cash equity asset classes additional thought is going to be required on how to derive a price that reflects the value that research brings, what its costs to produce, and the economic reality that if research is over priced their clients will not be prepared to pay for it. This will require investment firms to undertake an analysis of its costs of producing services categorised as research, using this information to determine a minimum price for which the research can be provided.

Whichever option is selected there will be technology changes that will need to be implemented to support the decision.

Governance and control

Appropriate controls, senior management oversight and audit trails must exist to ensure the research budget is being used in the client's best interests, and whether research is being classified correctly, regardless of whether the clients or the fund managers themselves are funding the research. Key to this will be the need to create or enhance existing reporting to facilitate payments, and allow both the buy and sell side to monitor the quality of research using feedback provided via mechanisms like broker voting, to help demonstrate and prove that research is not an inducement to trade. If investment firms do not already have these frameworks it may introduce further operational burdens, require system builds and an added layer of administrative costs.

Additional organisational changes may be also required to manage potential conflicts of interest and ensure there is an appropriate segregation between those that produce research that could be perceived to be independent, and the Front Office. Although in many instances this segregation may exist, it may require teams such as desk analysts or strategists rethinking where organisationally they should be aligned and whether that should or shouldn't be behind a Chinese wall.

Technology impacts

The new regulations will require a number of changes to technology that investment firms operate including:

- The need to build or augment existing pricing and/or commissions systems to provide enhanced reporting showing unbundled costs (splitting advisory and execution services) such that buy side firms can demonstrate that they have not been offered inducements to trade.
- The need to build or augment systems such that the sell side can provide aggregate and cumulative cost reporting to the buy side at least annually.
- Infrastructure will be required for sell side firms to be able to process direct and commission (i.e. bid-offer) based payments and to be able to monitor research payment accounts versus agreed budgets.
- The need to build or augment systems to meet the affiliated requirements around disclosures of costs and charges which will allow investment firms to demonstrate that they are not being induced to trade to the regulators and to their clients.

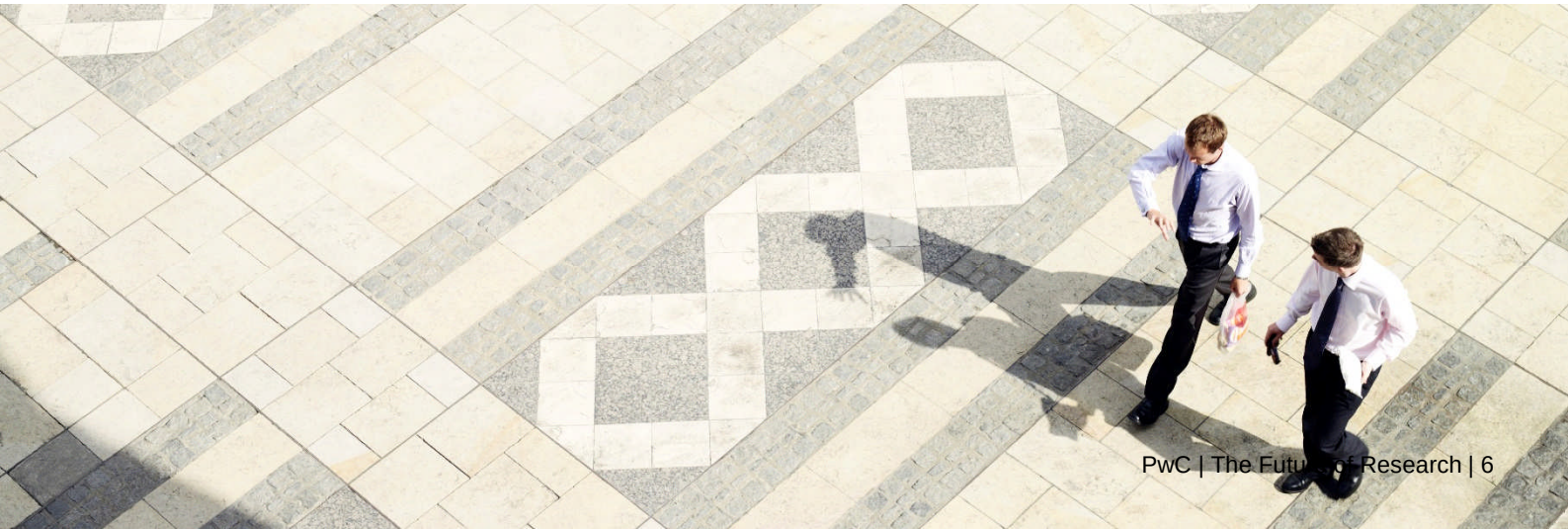
Industry implications

The new requirements will have far reaching implications on the industry

Implementation of the requirements will drive an increasingly efficient market with more competitively priced, quality research. Buy side firms previously receiving duplicitous, and/or low quality research, will become more particular about what they are receiving and who they are receiving it from as they will be explicitly paying for it in order to demonstrate they are not being induced. This could provide opportunity for independent research firms to fill in the gaps where sell side firms are not able to deliver on either quality or price, leading to a rise in the number of independent research providers and an increase in the number of services that sophisticated buy side firms bring in house. Possible implications include:

- Sell side research providers ranked between 1 and 5 in their respective sectors. It is likely that research from the large sell side firms with highly rated analysts will continue to be valued and sought after by the buy side. If these research providers transition successfully, they will be in a position to commoditise and monetise their research offerings.
- Sell side research providers ranked between 6 and 20 in their respective sectors. The mid-tier research providers may be those that are impacted the hardest by the MiFID II requirements. These firms could struggle to charge for research unless they innovate and find ways in which to differentiate their research or ensure high levels of value and quality are provided. For these firms, decisions to continue to provide a research service to clients will require a detailed cost-benefit assessment.
- Specialist or niche research providers. These will consist of either smaller, boutique sell side institutions, or independent niche research houses who produce specialist research that the larger firms find uneconomical to produce or for which they do not have the expertise. Due to the exclusivity of their materials and services, these firms are likely to maintain or increase their market share, as buy side firms are likely to value their services, and as some mid tier firms are pressured out of the market.
- The changes to inducement rules and potential unbundling of research payments creates the possibility of more VAT becoming due on charges going forward, and increased costs. The VAT treatment is not confirmed and there are complexities which are being explored both by individual businesses and also at industry forum level.
- The number of funds being sold by the buy side. Given the explicit costs associated with buying research, buy side firms maybe reluctant to pay for research, which in turn may impact their ability to build up sufficient market knowledge and expertise to set up and distribute new funds in asset classes currently unfamiliar to them. This in turn may have the impact of reducing the number of new funds coming to market.
- Research aggregators. It is likely that these firms increase in number or grow in size, as the buy side look to simplify how they acquire research, and as the smaller niche providers look for more attractive and expansive ways to distribute their material.

A potential unintended side effect on the industry could be the reduction of good quality research for the smaller and mid tier stocks. This could be both because mid tier firms stop producing research, but also because the buy side, who now need to demonstrate value for research being paid for, are less prepared to explicitly make payments for the analysis. This in turn may reduce the liquidity of these markets and lead to a widening of spreads for certain products. This is contrary to the intention of the regulators, who were seeking to tighten spreads with MiFID II to provide better value to end investors.



Building an approach to MiFID II

How we can help

Any impact on operating models and profit margins for investment firms will be dependent on how they choose to approach the challenges described in this paper. Firms that are willing to consider the long term, strategic view and evaluate the implications of MiFID II across their entire front to back operations, their client base and their product and service offerings will be better able to position themselves optimally in areas where their capabilities and resources allow them to use the regulations to build a competitive advantage. Specifically PwC can help through:

- Categorisation of services that are considered research.
- Review your organisational structure, develop target operating models and provide regulatory guidance.
- Help your firm to understand their cost base and so develop their pricing models.
- Review systems architectures to ensure that you are able to provide clients with the payments management and meet their disclosure requirements.
- Develop a supervisory framework, governance structures and provide assurance post implementation.
- Provide industry expertise so that your firm is not approaching the solution unilaterally.

PwC have helped a number of firms develop their MIFD II programmes and specifically support them with strategic decisions around the research challenges they face. This has been done collaboratively, considering both the business strategy and the competitor environment. We have helped investment firms how to categorise services that maybe considered research, provided advice on the drafting of new CSA's, defined requirements for system and supporting client portals, and set out new frameworks and operating models.

If you would like more information or support on:

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