As members of the European financial community attempt to develop a better understanding of the far-reaching consequences of the recent “Brexit” referendum to their business structures, many investment management firms are simultaneously preparing for changes to their research processes that will result from the implementation of the European Commission’s Delegated Acts for the Markets in Financial Instruments Directive (MiFID II) in January 2018. **While the investment research industry may see more changes in the next two years than it has in the last two decades, the most important word here is “MAY.”**

Since the Delegated Directive was published in April, many firms are studying what modifications and enhancements will be needed to their infrastructure and workflow to comply with regulatory requirements. As we await further guidance in the form of consultative papers from the respective European regulators, it is important to reconsider the potential impact that an increasingly complex and burdensome regime can have on the industry’s competitive landscape.

**Research Payments**
The EC Directive determined that the provision of research is not an inducement if:

- It is paid for directly with the investment firm’s own funds; or
- It is paid from a separate research payment account (RPA) controlled by the investment manager and funded via:
  - Specific research charges to the investment firm’s clients; or
  - Commission sharing agreements (CSAs) where a specific research charge is not linked to execution volumes or values.

Additionally, upon request, investment firms will be required to provide clients with information about the budgeted amount of research and a summary of providers paid, services consumed, amounts paid, benefits received and total amount spent in comparison to the budget.
Regulatory Considerations
The establishment of procedures to improve transparency over the cost and value of research is in the best interests of investors. Furthermore, a more rigorous research valuation and budgeting process creates an increased level of accountability and should theoretically create a more efficient marketplace that allows the most impactful research inputs to be paid commensurately.

The challenge for regulators and industry participants alike is to foster a more transparent research procurement process without creating an administrative and reporting environment that is exceedingly complex and onerous. The extent to which reporting requirements are more burdensome and costly when research is funded with client assets through an RPA will incent some investment managers to pay for research directly with their own funds. Already, a number of firms have indicated that they will consider paying for research services themselves.

Investment Management Considerations
Understanding that most businesses need to control their cost structures in order to remain competitive, there is a material risk that smaller and mid-size asset managers will be disadvantaged if the industry moves towards a standard of direct funding for investment research.

While the largest asset managers have adequate scale and internal resources to absorb the cost of directly funding a research budget, smaller and mid-size managers would be hard-pressed to compete in the long term. A lack of resources would put these managers at a distinct competitive disadvantage in terms of their ability to price their product competitively, attract investment talent, access a necessary range of research, and ultimately manage their clients’ investments.

Research Considerations
As we have said before, a vibrant and competitive marketplace for objective investment research is an essential foundation to the capital markets. Investment managers with access to more quality information should be positioned to more effectively allocate their clients’ capital.

The investment research industry is in a dynamic period of evolution. Our clients continue to enhance their research processes through the cultivation of new research inputs comprised of proprietary information and data that did not even exist several years ago. Many of these services are introduced to the marketplace by third-party, independent research firms whose existence is dependent on the use of commissions as a currency. It is safe to say that emerging independent research firms would have a more challenging time launching in an environment where they need to compete for payments from an investment manager’s own funds.
Similarly, boutique broker-dealers that cover niche industries will have a harder time supporting their capital markets businesses. For instance, a boutique broker-dealer focused on investment banking for emerging health-care companies would have a difficult time managing its investment banking business without some level of support from its research and trading businesses. A further byproduct of such a scenario would be the negative impact it would have on the emerging companies’ ability to obtain financing and come to market.

**Final Thoughts**
A vibrant, orderly and effective marketplace is inherently made up of a broad range of ‘buying’ and ‘selling’ participants. In the case of investment research, these include various types and sizes of investment managers, proprietary trading operations, investment banks, bundled sell-side brokers, execution only brokers and independent research providers. It is clear that the EC Directive recognizes the need for a variety of research payment models to support this broad range of industry participants and it is vital that Member States carry this recognition through consultation and implementation.

In the first half of 2015, industry participants were genuinely concerned that the forthcoming MiFID II guidelines could be interpreted to define investment research as a form of inducement. Many constituents – regulators, politicians, investment managers, investment research providers and others – cautioned that such a dramatic overhaul of industry practices that have worked well for over forty years would trigger many unintended consequences throughout the European economy.

While many in the industry breathed a sigh of relief when the EC’s Directive allowed for the use of trading commissions to fund an RPA, there is now a genuine risk that the level of scrutiny and cost of managing the budgeting and reporting process may be so burdensome to managers that larger firms with more resources will choose to pay for research directly using their own funds, which will put increasing pressure on smaller asset managers with fewer financial and other resources to follow suit. We are hopeful that regulators recognize these issues and foster an environment that is not unnecessarily taxing to smaller asset managers, ultimately leveling the playing field for investment managers of all sizes to acquire research from many different sources.
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