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INSIGHTS

What is MiFID II? And why should you care?

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EXECUTIVE SUMMARY

- The original Markets in Financial Instruments Directive ("MiFID"), adopted in 2007, harmonized financial services regulation to create a single, cross-border securities market across the European Union ("EU").
- A revised set of regulations, known as "MiFID II", will go into effect on January 3, 2018 to strengthen investor transparency and protections in Europe.
- MiFID II will affect any firm offering services related to "financial instruments" in the EU – asset managers, pension funds, brokers, retail investors, exchange-trade venues, and high-frequency traders will all be subject to the new regulations. Rocaton believes the effect of MiFID II will be very broad-based and few firms, even those domiciled outside the EU, will be able to avoid being directly or indirectly impacted.
- These new regulations are likely to have a significant impact on how investment research services are utilized and paid for as well as the transparency thereof.
- Other key areas of MiFID II that will be germane to fund managers include: 1) the separation of research and trading execution costs and 2) pre- and post-trade reporting practices.
- We note that, as a principal-based market, changes in the fixed income landscape may be profound due to the lack of infrastructure relative to equity markets.
- Many firms have already begun the arduous process of adjusting their businesses, but the subject is not well understood by market participants. The rules themselves remain open to some interpretation.
- Key considerations for clients include the cost impact of MiFID II to asset managers, the potential for fee savings for the end investor, and potential unforeseen changes to the market landscape after regulatory adoption.

Introduction

In 2004, the EU passed the Markets in Financial Instruments Directive ("MiFID") to synchronize financial services regulation and create a single, cross-border securities market in Europe[1]. The EU then proposed a more robust framework in 2014 to create new platforms, strengthen investor protections and improve transparency[2]. The revised framework, known as "MiFID II", will take effect on January 3, 2018 and will alter the interaction between traders, broker-dealers, analysts, and asset managers in European markets. Moreover, the new rules have the potential to significantly change how investment research is utilized and paid for, and the transparency thereof. With less than two months until the MiFID II legislation goes into effect, many firms have already begun the lengthy process of adjusting their businesses. However, some firms are not as far along as others and there is also a tremendous level of opacity on interpretation of the rules, without much clarity provided by regulating entities at this time. While adoption of MiFID II is required for firms managing money in Europe (or on behalf of EU clients), the changes will likely put additional pressure on large non-EU firms who are not required by law to comply with MiFID II. The successful adoption of MiFID II may also compel other mainstream regulators, such as the Securities and Exchange Commission, to consider adopting similar rules.

The balance of this paper will outline some key tenets of MiFID II and explore potential considerations for asset managers and clients. Overall, Rocaton supports MiFID II as it will likely lead to increased transparency for clients and a transition to research costs

[1] Markets in Financial Instruments (MIFID II) – Direction 2014/65/EU (link)
[2] Ibid

being borne by fund managers. Over the past year, we have engaged in dialogue with asset managers across asset classes regarding MiFID II to better understand the effects of the new rules. However, we also recommend that clients speak directly with their fund managers to ascertain what effect MiFID II will have on their businesses, how they are adapting internal processes to achieve compliance, and how specifically they, as clients, may be impacted.

Why MiFID II is important

Effective in 2007, the original MiFID was drafted to unite the European marketplace, increase competition, and provide consistent protections for clients. However, the original regulations did not contemplate continued fragmentation and the rapid pace of technological change (for example, the creation of dark pools and rise in high frequency trading). The financial crisis prompted calls to further reform MiFID and in 2014 the European Commission unveiled MiFID II. The components of the new legislation are considerably more detailed and prescriptive than the original MiFID.

MiFID II's underlying theme is 1) heightened transparency, across the structure of markets and the way in which asset managers operate, and 2) additional protections for clients. The new rules will force firms to be clear about their costs and fees, and explain them in a standard fashion. To achieve this, MiFID II addresses nearly all aspects related to the business of launching, operating, and marketing investment strategies in bonds, stocks, derivatives, and commodities to clients. Areas of change that fund managers will be required to evaluate include:

- Transparency of pre- and post-trade reporting
- Best execution
- Archiving communications
- Unbundling of research and trade execution costs
- Recordkeeping
- Appropriate client profiling and disclosures
- Additional regulation of trading venues

To be compliant in key areas, investment firms will need to record, analyze, and report vast amounts of data across their investment, trading, risk, compliance, operations, and accounting functions. Perhaps most importantly, the added compliance requirements from MiFID II and the extension of its scope could compel strategic considerations that regulated entities must address. Investment firms with international operations, including those domiciled in the United States, may need to create policies and procedures to comply with international rules that are similar in intent to American laws, but differ significantly in features.

Some Key Considerations for Clients

There will be many key considerations for clients stemming from the new MiFID II regulations, some of which are itemized below.

MiFID II is a cost to fund managers

Clients invested in Non-US strategies – either with US-based managers or with firms domiciled in the EU - should be particularly interested in how MiFID II will affect fund managers in their portfolio. MiFID II compliance is likely to be a costly endeavor for fund managers. It will be important to gauge the extent to which a firm has directed resources to respond to MiFID II and whether they have enhanced their administrative and operational resources. As early as January 2016, some EU-based firms have identified key workstreams to address the primary internal areas affected by MiFID II and have been working to create solutions to comply with MiFID II. We note the cost of MiFID II compliance is not solely monetary – the effort will need to be ongoing, and clients may wish to understand the extent to which key senior professionals, including the investment team, will have to dedicate time to ensure the firm is compliant. As the goal of MiFID II will be to increase transparency, we recommend that clients pay attention to disclosures and other reports provided by fund managers in the coming months.

There are potential fee savings for clients

Many EU-based equity fund managers with whom we have spoken will be absorbing the cost of research directly onto their P&L. This is a positive outcome of the new legislation, and we believe these firms are doing the right thing in bearing the cost of research instead of passing costs to clients. Several major global asset managers have also indicated that they will absorb research costs in their EU-based subsidiaries, which is encouraging. However, clients should follow up on whether these firms' non-EU operations will receive similar treatment. Naturally, we are watching to ascertain if truncated research budgets will change internal collaboration across global teams, or slow the development of research insights. We also remain concerned that clients in non-EU regions may be inadvertently subsidizing the cost of research in the firm's other offices or for asset classes in which asset owners are not investing.

It is difficult to predict the impact on the broader market opportunity set

It also remains to be seen how the new rules will alter the opportunity for stock selection, or affect the idea generation of fund managers. Within the broader market, there may be less "herding" as managers become more selective in what research content they receive. If research providers are less incentivized to cover niche markets, there could be an increase in inefficiency in parts of the market with fewer eyes on that space. For fund managers, it is difficult to identify or even quantify the intangible benefits or costs of using research. It is conceivable that the quality and content of research may improve as payment unbundling provides better opportunity for niche research firms to add value. Firms that stop supplementing their research effort with external research may be unaffected by a different supplier universe; it is also possible that firms reliant on external research may benefit from less noise or, conversely, may struggle if the flow of information is less robust. Fund managers that face budgetary constraints may have to prune their consumption of research, which may affect investment results. Some firms may seek to boost their internal research capabilities, which may be beneficial to the investment process but will be an added cost.

Which firms will be affected by MiFID II?

While the rules pertain to the EU, Rocaton believes the effect of MiFID II will be broad-based and few firms will be able to avoid being directly or indirectly impacted. Each investment firm, regardless of where it is incorporated, will need to assess its operations and services provided to European investors or counterparties. We note that institutional assets continue to consolidate at large global firms, changes instituted in response to MiFID II should resonate industry-wide, perhaps adding pressure indirectly on non-EU firms (such as US-based fund managers) and potentially providing a path for other mainstream regulatory authorities to consider the adoption of similar parameters at some stage. Figure 1 provides a brief summary of which firms, by location, will be affected by MiFID II.

Figure 1:

MiFID II Impact by Firm Location

Location of Firm	Firm Type	Impacted by MiFID II	Comment
EU Member States	• Fund Managers • Broker-dealers • Placement Agents • Investment Advisors	Yes	Directly Impacted
Domiciled outside EU (with EU-based subsidiaries, investors, or counterparties)	• Fund Managers • Broker-dealers • Placement Agents • Investment Advisors	Possibly	• Firm's EU-based operations will likely need to comply with MiFID II • Global asset managers may need to reconcile the regulations mandated by the EU with other rules (such as SEC regulations)
Domiciled outside EU (with no European clients or operations)	• Fund Managers • Broker-dealers • Placement Agents • Investment Advisors	Not at this time	• No mandate for compliance but may feel indirect pressure as global peers will maintain MIFID II compliance

Source: Rocaton

In terms of asset classes, MiFID II will affect any firm offering services related to "financial instruments" in the EU – asset managers, pension funds, brokers, retail investors, exchange-trade venues, and high-frequency traders will all be subject to the new regulations. Equity and fixed income managers will be impacted by MiFID II, to varying degrees. We note that, as a principal-based market, changes in the fixed income landscape may be particularly profound due to the lack of trading infrastructure relative to equity markets. Alternative investment management firms are also likely to be impacted by the new regulations. Private equity firms that manage and operate funds could be exempt from MiFID II if the firm does not offer any other financial service to the market.

The Effect of MiFID II on Research

For firms investing in public securities (either equities or fixed income instruments), the impact on the investment research ecosystem will be significant. We enumerate some of the key developments and encourage clients to pursue conversations with fund managers to better understand how specific entities are affected by and reacting to the new rules.

Under MiFID II, investment research must be purchased directly by the fund manager using their profit and loss accounts (P&L) or through a ring-fenced research-payment account ("RPA") with a clearly identifiable audit path. Historically, investment research was built into the cost of execution on a single invoice and was usually passed through to the end investor. MiFID II hopes to provide additional transparency on how much specific services cost, and ensure lower conflict-of-interest risk and no inducement to trade. Beginning in 2018, buy-side EU firms paying for external research using client commissions must break out the costs of execution versus research, and indicate how they allocate commissions across providers and disclose that on materials made broadly available.

Separating research from execution will have notable effects on research as a service, and may eventually obviate today's investment research model. First, asset managers will be forced to identify substantive research (for example, would "color of the market" calls from sell-side firms be considered research?) and then consider what is the "right" price for it, regardless of whether it is paid for by P&L or RPA. These are both complex questions because research differs in perceived importance and value. Inevitably, firms may be more judicious about the research they receive and who they receive it from, especially if the content is duplicative or not additive. As a principal-based market, this is an especially sticky subject for fixed income, where there is little transparency on the value of research and where costs tend to be embedded in the spread. To comply with MiFID II, asset managers must provide a trail of explicit payments for research and further demonstrate that purchased research has been additive to investment decisions and is thus not an inducement.

Sell side firms are clearly impacted by the changes wrought by MiFID II. The full "unbundling" of services will require broker-dealers to build or buy appropriate technology infrastructure to categorize and identify a price for research. They must separately charge for it along with trading and other advisory services, and then manage payments from a variety of entities and attribute payments appropriately. The question is complicated when the broker-dealer is a global firm selling research and execution services to US firms with international operations, or to EU-based global firms.

Transparency of trading costs across equity and fixed income markets

Regarding the subject of transparency to improve price discovery and achieve best execution, the original MiFID rules were limited to shares traded on regulated markets. Beginning in 2018, the MiFID II regulations have been substantially expanded to cover equity-like instruments (exchange-traded funds, depository receipts, etc.) and non-equity instruments including derivatives, bonds, and structured finance products. MiFID II expects to achieve transparency through 1) pre-trade disclosure to market-participants of all EU over-the-counter basic trade data and quotes in real time (within fifteen minutes) and 2) post-trade disclosure to market-participants with real time information on executed trades . Pre- and post-trade reporting will be required for all financial instruments and will identify the client and his/her investment decision, as well as the trader involved in the execution.

Conclusion

The MiFID II regulations, which will take effect on January 3, 2018, have the potential to significantly change how research is utilized, paid for, and the transparency thereof. Many firms have already begun the arduous process of adjusting their businesses, but the subject is not well understood by market participants and the rules themselves are nebulous and open to interpretation. Overall, we remain supportive of the overall goal of transparency for the end investor, and are hopeful that MiFID II will compel asset managers to rescind the standard practice of paying for external research expenses through client trading commissions. Rocaton believes that the changes wrought by MiFID II will likely put additional pressure on large non-EU firms who are not required by law to comply with MiFID II, but will nevertheless pursue equal treatment of clients regardless of where they are based. Over time, the successful adoption of MiFID II may in fact compel other mainstream regulators, such as the Securities and Exchange Commission, to consider adopting similar rules. Rocaton will keep closely abreast of the news and industry changes as MiFID II is adopted, and will continue to undertake discussions with managers to monitor implementation of MiFID changes on behalf of our clients.

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