Mifid II research unbundling: “It has changed everything and nothing”

Published 31 Jul 2019 **Last Updated** 31 Jul 2019 11:49

Author: Hugo Bromley, London

Mifid II has not yet reduced conflicts of interest in the sale of research, according to several sources speaking to Practice Insight.

“It has changed everything and nothing,” a senior source at a major US asset management firm told Practice Insight. “We all know the perception [of conflict of interest], and we still keep it in mind.”

Article 24 of Mifid II, implemented in January 2018, requires asset managers to separate commissions into their component parts. The change sought to create a clear and separate valuation process for external investment research.

However, 18 months after implementation, the market is yet to find a way to appropriately value research. Several sources said that research provided by investment banks is still so cheap that it’s hindering the emergence of a competitive market.

See also: Mifid II accelerates automation of investor services

"I understand what they were attempting, I don't think they succeeded," the CEO of an international brokerage and investment firm told Practice Insight. "If you run a cross-subsidised model, there is always an incentive to push down prices."

The Financial Conduct Authority (FCA) expects asset managers to independently monitor whether low pricing levels may suggest conflicts of interest. Yet as Substantive Research CEO Mike Carrodus said, it is a difficult balance for buyside firms to strike.

"It's a bizarre job," he said. "You don't want to pay too much, but there's a compliance risk to paying too little."

KEY TAKEAWAYS

- **Mifid II has not yet reduced conflicts of interest in investment research;**
- **The pricing of research is often still so low that research becomes a de facto inducement;**
- **Sources do expect that competition will increase quality reduce conflicts of interest over time;**
- **IRPs are hoping to benefit, but are also increasingly turning to corporate-sponsored research as the buyside research budgets shrink.**

Reduced budgets also mean asset managers are using fewer sources of research, making it hard for them to recognise when they receive a price the FCA might consider unacceptable. "Firms become a little blind to anything that isn't on their list of providers," Carrodus said.

Complicating the matter further, research on fixed income investments tends to be treated as what Mifid II defines as a minor non-monetary benefit, and provided free of charge. "If you're managing equities, you are working next to a fixed income manager receiving their research for free, while yours is in theory priced, but so low that it is essentially an inducement," the brokerage CEO said.

See also: Small asset managers struggle with Mifid unbundling costs

A long game

However, some sources expressed a belief that it in the long term, the need to justify research spending would drive up quality and reduce conflicts.

Initially, banks sought to maintain broad research coverage to continue to support their wider businesses, Carrodus argued. Yet recently, several sources have detected an emerging flight to quality due to the pressures placed on portfolio managers to justify their research spend.

As the market becomes more competitive, they expect that objectivity and conflict of interest reporting will become key selling points for research providers. "The buyside understands the value of research in a way they never did before," said Carrodus.

Reduced supply may also push up prices. "I'm optimistic that there will be some increase in pricing," the brokerage CEO said, "if only because supply is being taken out."

See also: UK firms start receiving Mifid II FCA letters

Other sources believe fintech companies will accelerate this trend. “Regulation has encouraged fintechs to offer new products, and that presents a wider opportunity for firms interested in investing in order to raise the bar,” said Natasha Leigh Giles, managing principal in financial regulations at Capco.

She described the combination of technology innovation and regulation as a perfect storm that allows firms to better manage potential conflicts of interest as part of their efforts to enhance competitiveness, both in Europe and the US.

Rival conflicts

If the market grows more competitive, independent research providers (IRPs), who have struggled to compete with the prices offered by investment banks, are hoping to benefit. “The genuine independence of IRPs is a key selling point,” said Steve Kelly, CEO of trade association Euro IRP. He described the last 18 months as ‘challenging’.

However, with research budgets continuing to shrink, IRPs are actively encouraging conflicts of their own to survive. Both Kelly and Maxime Mathon, head of communications at Alphavalue, pointed to a rise in corporate-sponsored research as a future trend in the industry, particularly in mainland Europe.

See also: Mifid II in Asia: big buyside clashes with regulators, domestic firms

‘Transparency can overcome conflicts – for instance, if you say [that research is sponsored] to the buyside, demand 100% of your payment upfront and commit to covering for a fixed period,” Mathon added.

In Germany, regulators expect sponsored research to play an increasing role in the research market over the next two years.

However, while they expect sponsored research to play a greater role, few sources believe sponsored research would become a truly significant factor. Carrodus expressed doubt that sponsored research would gain credence with asset managers.

The US asset manager accepts that sponsored research could be valuable to smaller companies. However, he was blunt about the risks. As he put it: “We don’t see very much negative research coming out on companies that are paying for it”.

Though competition may have an effect in the long term, for now, investment research remains an inherently conflicted market.