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MiFID II Research Valuation & Budgets – The End of the Beginning?

Recent FCA guidance on the implementation of MiFID II is the 'starting gun' for global research process transformation. The asset manager's research budgeting process, and the way in which it is communicated to asset owners, will become a major competitive battleground for asset managers. Here's what asset managers will have to consider when constructing strategy-level research budgets.

In November 1942, during the darkest days of World War II, Winston Churchill made a famous speech in which he declared: "This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

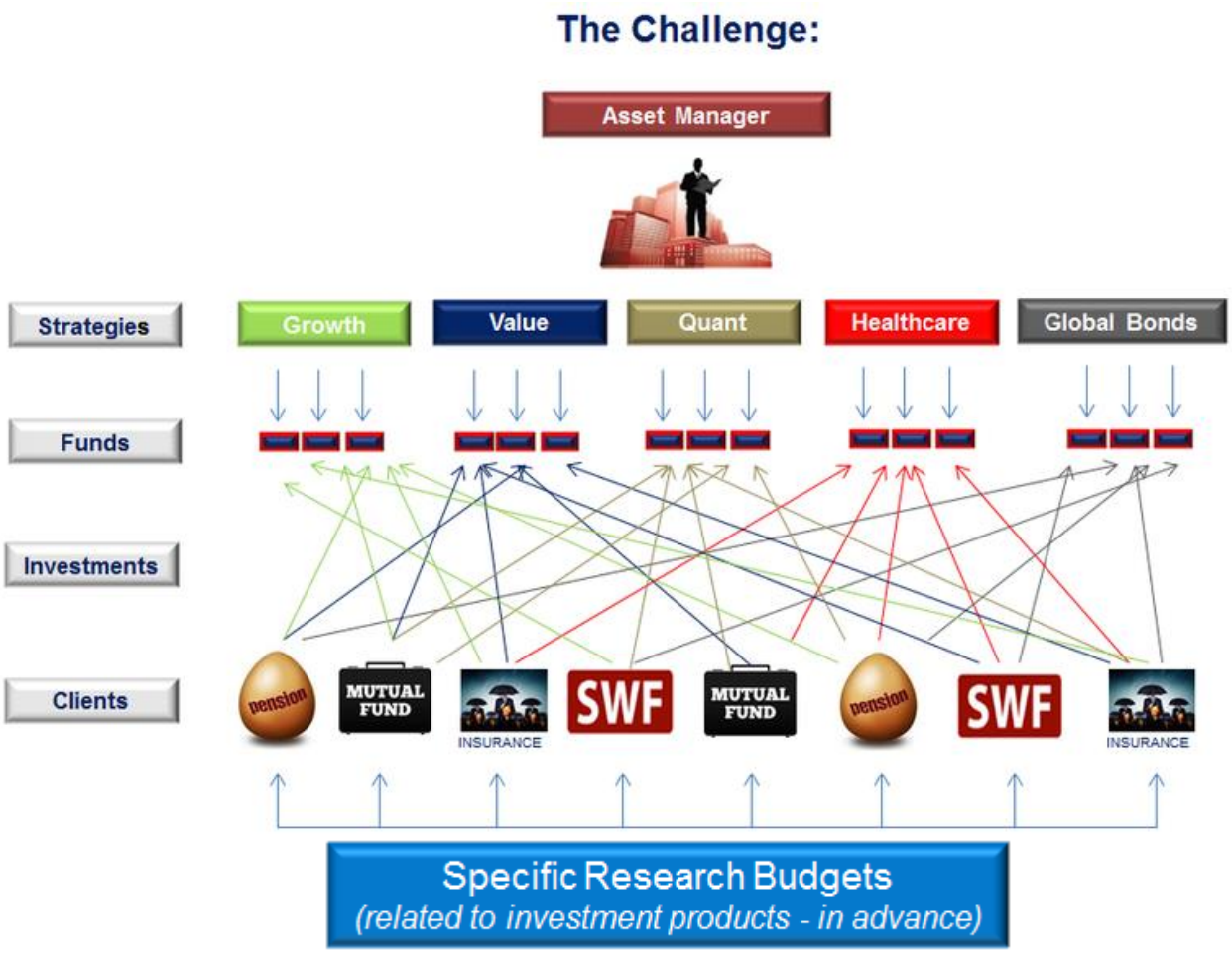
The 15-year battle over research commission funding is entering its crucial and decisive phase as the MiFID II January 2018 deadline poses serious challenges for the research operating models of global asset managers. The final piece of the regulatory puzzle was revealed in the FCA's recent MiFID II implementation Consultation Paper, cp 16-29 – the most anticipated major regulator to interpret the Delegated Acts.

In the FCA document we learned that:

- Managers who use client money for research (either "Swedish Model" or CSA/ RPA) will have to construct strategy-level monetary research budgets to allocate research costs to clients, and document why particular funds were grouped into specific strategy budgets. (Some in the industry had hoped that firm-wide budgets would suffice.)
- Managers will have to develop a formal research valuation policy that explains their approach to research valuation and the methodology for fairly dividing research costs between clients. (Equivalent of "Best Execution" Policy under MiFID I.)
- All asset classes will need to construct research budgets, including fixed income.
- Asset owners will have to be informed of the specific portion of the manager's research budget (related to products in which they were invested), in advance and (essentially) have to agree to their managers' proposed research budgets.
- This regime will also be extended to UCITS funds, at least in the UK.
- Regulators and asset owners can ask managers, ex-poste, for a very detailed account of research spend, by producer and product, and how that spend compared to the allocated budget.

- Managers will need to keep a list of research services received and how they benefitted the portfolio.

Why, then, is this long-awaited regulatory clarity not the end of the journey? Because the challenging multi-faceted process of asset managers deciding how to implement these requirements has just begun.



Asset managers will have to consider the following issues when constructing strategy-level research budgets:

1. How large ($) will the overall research budget need to be to acquire essential research services?
2. How many research budgets will be needed?
3. How to decide which funds are allocated to which strategy budgets? (This will be complex for large global managers with hundreds or thousands of products/mandates.)
4. How large will the top-level dollar value of the individual strategy budgets be?
5. Do all strategies need the same amount of research and therefore similar budgets?
6. How to allocate research costs to specific clients, based in their investments – in advance?
7. How to construct fixed-income and other non-equity asset class budgets in light of the difference in the payment mechanism between equities and other asset classes and that fairly can allocate research costs in multi-asset class products.
8. How to convert obsolete "broker-vote" systems into a harmonized research valuation process that places monetary values on all research including (unpriced) investment bank research, priced independent research and research related to non-equity asset classes?

9. How to accommodate the fact that numerous PMs and analysts work on many different investment products? Multiple broker votes per product?
10. How to meet the most challenging MiFID II requirement of "demonstrating research value to the portfolio" by linking research selected to the product's actual strategy/investment process.
11. How will this affect non-European clients that may not be technically covered by MiFID II and, by extension, policies towards all clients?

Where do the lines between internal policy and external client engagement cross?

It's Not About Compliance – It's About Alpha (and Competitive Positioning)

Research selection, valuation and payment decisions were once the sole province of the investment department. Those nostalgic days have been completely eclipsed by the MiFID II environment. The CEO, CIO, Legal, Compliance and Marketing will all be intimately involved in critical decisions regarding the asset manager's implementation policies of MiFID II on research issues.

These policy decisions will have a direct impact on the asset manager's investment process; investment returns; level of profitability; and competitive positioning.

In the MiFID II environment, asset owners will receive increasing numbers of disparate research budget proposals from their managers, many running similar mandates.

Consequently, the asset manager's research budgeting process, and the way in which it is communicated to asset owners, will become a major competitive battleground for asset managers.

To achieve a competitive advantage, asset managers have to be able to:

- articulate a coherent research budget strategy that is an extension of their investment process
- demonstrate research spending ROI
- link research budgets directly to asset owner investment objectives

Managers will likely have to start delivering product-specific research budget proposals to asset owners covering the 1Q 2018 period in 3/4Q 2017.

This suggests they should have a process in place that addresses these questions by the end of 1H 2017 – otherwise, the beginning may seem never-ending.

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