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Eighteen Months In, MiFID II's Impact on Research and Execution Is Felt Far and Wide

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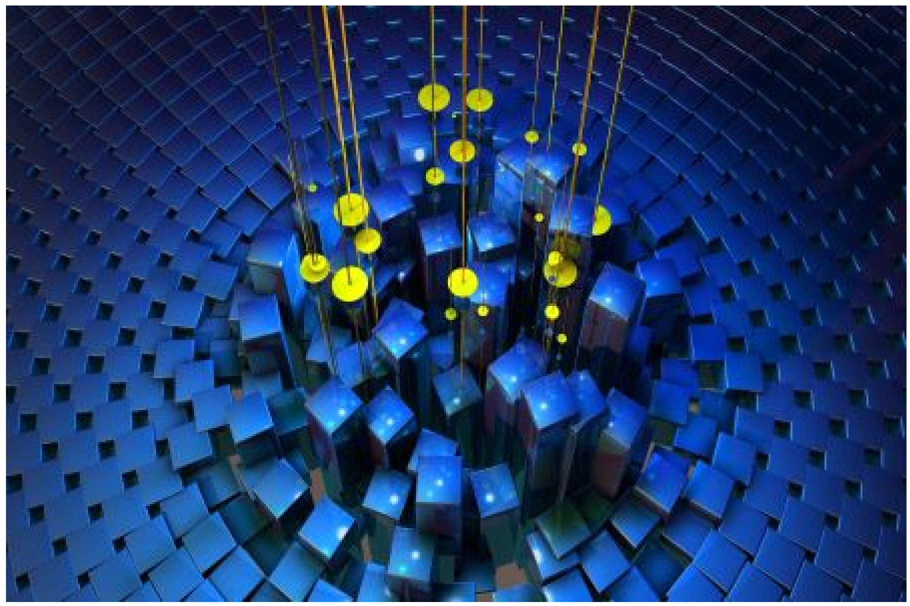
A group of investment professionals discuss the ramifications of MIFID II after 18 months and offer their insights into the impact the regulation has had on research and trading, not just among European money managers and brokers, but also how the law has affected their brethren in the U.S.



With the COVID-19 pandemic and the record volumes and volatility that came with it still fresh in our minds, it feels like a natural time to look back on the last time the financial services industry faced wholesale disruption. A year and a half ago this month, MiFID II was implemented by the European Union, and the wider world has been dealing with the fallout ever since.

As most capital markets professionals are well aware, MiFID II is a sweeping, multifaceted overhaul of the European financial services industry. Its requirements of best execution and the resultant unbundling of investment research from execution services have had a particularly significant impact. These shifts accelerated ongoing trends and sparked new ones, in many ways providing the framework for the industry as it exists today.

Global Impact

It's important to note that while MiFID II is legally binding in EU nations only, its ramifications have transcended national borders. A recent report (https://www.thetradenews.com/europes-unbundling-regime-continues-take-hold-buy-side-globally/) from Liquidnet found that just 12% of buy-side survey respondents had ring-fenced European operations for unbundling, while 70% had implemented a global unbundling policy, a significant increase from the previous year's rate of 53%. While trading in multiple regions has and always will require greater compliance costs, the asset management industry has largely decided that it is not worth it to maintain separate workflows in this arena, and now the writing is on the wall: MiFID II is poised to make a global impact for years to come.

This has had a major effect on the business of Wall Street research. The mass unbundling has brought into sharp focus the amount that buy-side firms are paying for research. While this has caused many managers to slash their research budgets with the bulge brackets, it has also represented an opportunity for independent research providers (IRPs).

"Generally speaking, MIFID II has damaged the production of equity research, notably in small- and mid-cap names," said Aaron Hantman, CEO of Tourmaline Partners, a leading provider of outsourced trading solutions. "While the sell side has become more selective in its offerings, unbundling has also created greater price transparency and thus a path for entrepreneurial sell-side analysts to launch their own businesses."

This is a continuation of an attitude that has been present on the buy side for a number of years, according to Mike Kronenberg, CEO of Analyst Hub, an independent research infrastructure platform company that provides sell-side analysts with a path to owning their own enterprises. Increasing cost pressures have long meant that buy-side firms will seek to untether their various dealings with the sell side from one another and identify the key difference-makers for their businesses, resulting in a kind of soft unbundling – the difference is that now, it's on the books.

"MiFID accelerated a trend that was happening for a while on the buy side of only paying for what you value, not taking any and every resource offered by the traditional 'buffet' the sell side offers and tries to make you pay for," Kronenberg said. "Active management fees are under pressure and buy-side firms are pushing the cost of consumption of resources to the individual fund manager's team.

This is actually what we address at Analyst Hub: unlocking a sell-side analyst's own value. If a portfolio manager has to decide to pay for you, why do you have to subsidize the big bank cost structure?"

Navigating Disruption

Of course, the impact on the research businesses and professionals themselves is only one piece of the equation. Buy-side firms have a number of tools at their disposal to make their interactions with the sell side more profitable on the whole, and many of these have been affected by MiFID II.

In the U.S., one of these is Client Commission Arrangements, or CCAs. CCAs provide a framework to highlight the costs of both research and execution in a bundled commission. This allows the buy side to pay for research as part of the trading process, as it has been for years, while remaining compliant with unbundling regulations or policies.

As an independent execution services provider, Tourmaline Partners is in a unique position to provide commission management services and has scaled this offering to meet client demand, says Hantman. In addition to managing CCAs and CSAs for clients around the world, Tourmaline offers attributed trading. This offering means clients may direct trades to brokers of their choice in order to receive research and other services, even if the client does not have an existing relationship with the counterparty in question.

"An outsourced trading firm should have a comprehensive commission management infrastructure to fund research on their clients' behalf," said Tim O'Halloran, Managing Director at Tourmaline. "This should include the ability to attribute and carefully track sell-side research funding as well as an internal CCA/CSA offering to compensate independent research providers and non-core broker-dealers. This ensures the flexibility to seek best execution in a transparent and unbundled manner. A good outsourced trading firm works in conjunction with the sell side to remunerate them for all of their services: research, conferences, corporate access, analyst access, color, et cetera – on behalf of their mutual clients."

Most buy-side entities under the jurisdiction of MiFID II no longer use CSAs. Meanwhile, in the U.S. and elsewhere, commissions continue to be the currency of exchange to acquire research from all sources, with CCAs and CSAs providing the flexibility to seek best execution.

"Perhaps the biggest difference between the two regions is that many European asset managers opted to pay for research costs from their own pockets rather than adopt convoluted procedures for passing on research costs to asset owners," said Sanford Bragg, CEO of Integrity Research Associates. "This resulted in reduced research spending by European asset managers and is particularly onerous for smaller European asset managers, which is one reason European regulators are considering softening some of the rules."

Unbundling is just one piece of a complex equation. Proving best execution can be an onerous process, requiring extensive reporting and analytics. This explains the continued rise of the agency model, in which brokers do not hold an inventory of securities and instead have a formal responsibility to seek out and execute the best transaction on behalf of their clients.

In order to thrive in today's environment, many agency brokers have built systems designed to streamline best execution. DASH Financial Technologies, which delivers high-performance solutions for trade execution and analytics, as well as a suite of tools for regulatory capital compliance, is one such firm.

"Today, brokers who want to have a serious execution offering must not only be able to offer a full tool kit to deliver best execution directly to the buy side or through sell-side partners, but they must also be able to demonstrate how client orders are executed through transparency analytics and post-trade reports," said Stino Milito, co-COO at DASH. "Unquestionably that is a positive for investors, and very much in keeping with the spirit of what regulators intended when enacting MiFID II."

Bolt from the Blue

If MiFID II is a rising tide, the arrival of the COVID-19 pandemic was a bolt from the blue. The result was not just huge spikes in volumes and volatility, but also an extended work-from-home protocol that is still in place for many in the industry. This has had significant implications for best execution.

"Not only has volatility been high, but spreads have often been wider with less available liquidity," said Milito. "It is therefore more critical than ever to capture liquidity at a high rate, and that shines the spotlight squarely on the quality of order routing."

There is no telling how the rest of this year will play out, but one thing is clear: MiFID II, technically unchanged since it was implemented in 2018, is still evolving in terms of its effects on the industry. It has become a truly global framework and altered practices and budgets in the process. It is an important ongoing chapter in the story of global market structure – striving to find a balance between protection and efficiency and adjusting practices in the name of fairer markets for all.
