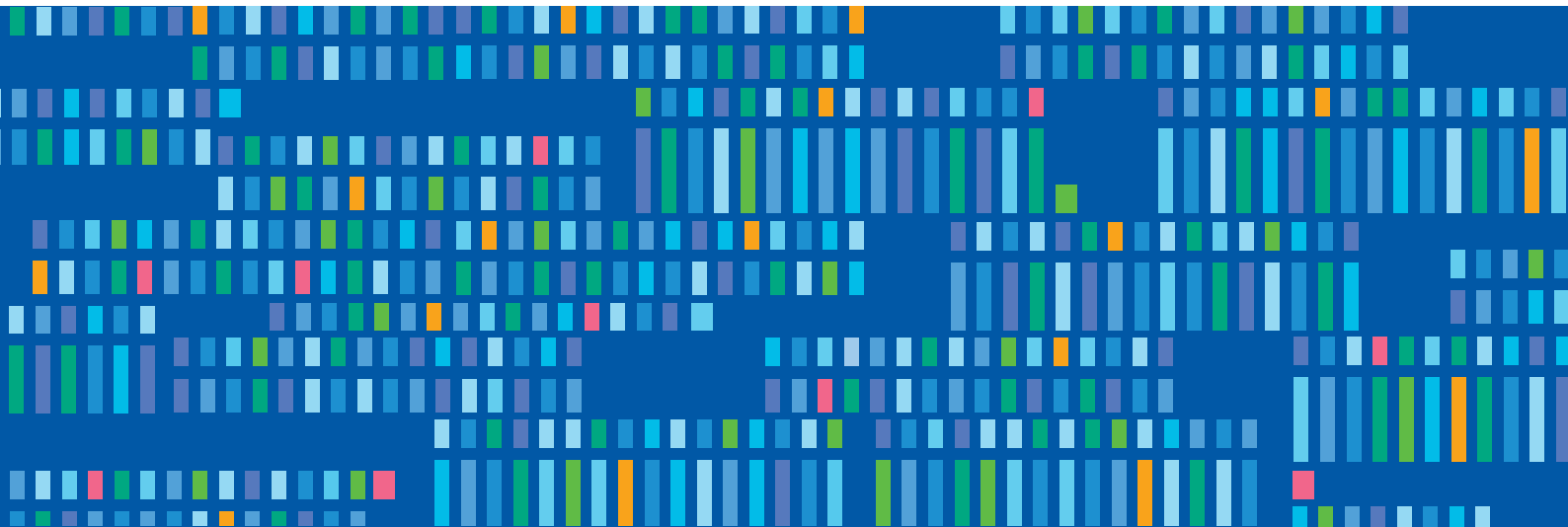


MiFID II: ONE YEAR ON

An Assessment¹

April 2019



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¹ CFA UK is grateful to the following members of the MiFID II Working Group for their input into this paper: Esther Akinwolemiwa, CFA, Aamir Ansari, CFA, Andy Burton (chair), Massimo Catucci, IMC, Nataliia Gaidarenko, Yonnie Kasigi and Pradeep Pratti, CFA. Views expressed are those of CFA UK and not necessarily those of the working group. The working group members are acting in a personal capacity.

Executive Summary

- Most of our interviewees were supportive of the aims of MiFID II regulation, identifying the main benefits as (i) a reduction in research costs for end-clients², (ii) better accountability in research procurement and (iii) greater transparency on costs and charges for the end-clients. Opinion was more divided on whether all of these goals had been achieved yet and there were concerns about the longer-term consequences of the forces unleashed by the MiFID II reforms.
- Of the stakeholder groups interviewed, the sell-side had been most impacted. There were examples of small firms closing and mid-tier firms restructuring. One global bulge-bracket house we interviewed had chosen to ride-out the storm but noted some peers had taken earlier action and made reductions, often of senior headcounts. In the investment and product governance departments of the buy-side and with corporates, MiFID II has imposed a significant up-front and on-going administrative burden but has not led to wide-scale restructuring. Independent research houses were intended to have become in theory unfettered, but in practice have been caught in the cross-fire between buy- and sell-side and suffered in the drop in the market value of research that the reforms have brought about.
- As our interviews reveal, financial markets are far from homogenous and contain a multitude of firms with different business models in all sectors. What has been fascinating about conducting these interviews is that it is impossible to make one rule for all, as there is always room for the exception: the asset owner that unbundled research in 2006; the vertically-integrated product manufacturer and distributor; the conviction strategy asset manager that procures almost no sell-side research.
- Most interviewees believe that the MiFID II reforms will eventually succeed in meeting most of its objectives. However, the jury is still out and, as in all markets, there are hopes and fears for the longer-term future:
 - The hope is that the shock and cost of the increased administration and data reporting will over time fall away as technology catches up and processes become automated. It is also that research quality will improve, become more relevant and targeted to the real needs of clients and that the overall cost to end-clients will remain lower (and compound);
 - The fear is that, for both buy- and sell-side, only the large global players will survive and that MiFID II will act as a catalyst in the increasing consolidation of both buy- and sell-side sectors and also stifle the arrival of newcomers. It is also that small- and mid-cap equity research could increasingly become the preserve of issuer-sponsored research (which already existed pre-MiFID II, but which is now gaining market share), with its heightened conflict-of-interest with end-investors, leading to a less fair and effective market in the equities and corporate bonds of smaller and less liquid issuers.

Introduction

Background to MiFID II

MiFID II represented the biggest regulatory overhaul of the European financial services industry in a decade. Introduced on 3rd January 2018, regulators had been running extensive consultations on the proposed legislative package from as far back as 2014. The new regulation was wide-ranging, introducing new rules to govern the payment of investment research, new trade transparency requirements, strengthened requirements around the provision of investment advice and new product governance rules.

This paper has been developed by a team of CFA UK volunteers who held 20 interviews across asset management, asset owner, investment banking, corporate IR and independent research organisations during January and February 2019 to capture a broad

range of opinion on the impact of MiFID II one year on from its implementation.

Without doubt, MiFID II has brought about fundamental changes, though there is definitely a debate to be had as to the extent to which some of these changes were already underway.

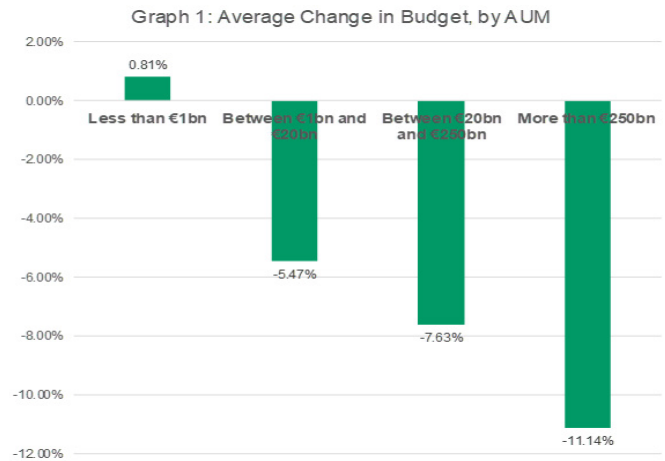
To keep the project manageable, the interviews focused mainly on the impact of both the unbundling research reforms and to a lesser degree, the new product governance rules. The aim of this paper is to complement the findings of the CFA Institute's high-level quantitative membership survey with more granular case studies from a diverse group of affected organisations and firms, thereby adding more colour to the overall picture.

² The FCA recently quantified these as £180 million per annum, or nearly £1 billion if extrapolated over 5 years <https://www.fca.org.uk/news/speeches/andrew-bailey-keynote-speech-mifid-ii-european-independent-research-providers-association>

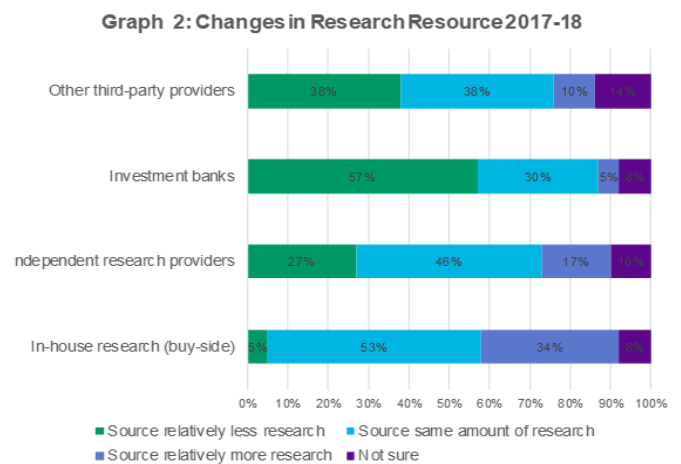
Highlights of CFA Institute Survey

The CFA Institute conducted a survey of its European members between 6th and 19th December, 2018³. The survey went to 12,633 members in European Union, United Kingdom and Switzerland. In total 496 responses were received, for a response rate of 4% and a margin of error of +/-4.3%. Respondents came from 449 firms in 25 different European countries.

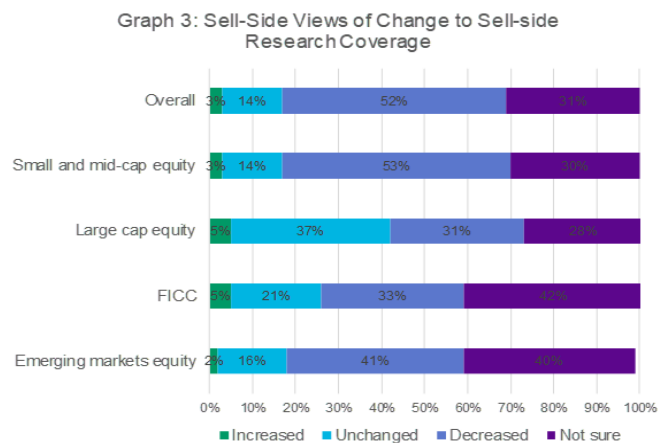
Firstly, as seen in Graph 1, the largest buy-side firms have been able to cut their research budgets most, whilst the smallest firms spending on research may even have marginally increased.



Second, as seen in Graph 2, the buy-side have on average reduced the amount of sell-side research they are consuming and increased the amount of research produced in-house.



Third, as seen in graph 3, as investment banks have scaled back their research operations to reflect the lower revenues they receive, they have largely opted to reduce the coverage of small- and mid-sized rather than large-cap equity stocks.



³ <https://www.cfainstitute.org/en/research/survey-reports/mifid-ii-one-year-on>

The Sell-Side View

We interviewed the management of the equity-side of one global bulge-bracket firm, an analyst at a mid-sized equity brokerage, the management at a mid-sized equity and debt brokerage and a High Yield credit analyst at a mid-sized brokerage.

The unbundling of research as a result of MiFID II made research consumers rethink their research budgets and as a result the sell-side probably has been the most impacted overall.

Restructuring

To some extent, all players had to review their structure and operational model: some small tier-3 firms closed or are under threat of closure, having lost key analysts. One sell-side firm restructured and moved to an execution-only model, investing in technology to offer cost-saving solutions on execution for their clients. Another firm moved from a "desk-analyst" to a "publishing-analyst" model, as 'trade notes' were now captured as 'research' under MiFID2.

As a general trend, many (but not all) sell-side firms pared back analyst numbers, merged teams and reduced analyst seniority. However, star analysts still have been retained in bulge-bracket firms in those sectors where the bank has a strong, strategic corporate franchise.

Revenues

Anecdotally, as a fall-out from the Global Financial Crisis, sell-side revenues halved from their peak in 2008 to 2016 as MiFID II came live. Interviewees universally expect that number to have continued to fall. In Equities, research fees have seen swingeing cuts, particularly from some of the larger asset-managers. In contrast, Fixed Income research fees are new and so are incremental revenues to the sell-side that were not received

before; they do not come close to being able to off-set the revenues lost in Equities, however.

Coverage & Quality

All interviewees mentioned that small- and mid-cap companies have seen declining coverage and as a result these companies may have lost investors. We heard of sell-side firms that had sent around formal notifications listing stocks that they were no longer going to cover. Mega-caps remain, as expected, very well covered, though overall the number and experience of analysts has decreased.

We heard mixed views on research quality. Ironically the consensus was that quality had fallen in Fixed Income, despite the additional revenue; in Equities, the picture was more mixed.

Contact & Corporate access

The sell-side analyst's relationship with the buy-side changed as MiFID II made the contact part of the relationship chargeable. In some firms, the sell-side now has a diminished hold on the conversation between the asset manager and the corporate. They are also getting fewer incoming calls from the buy-side and these calls have become shorter and less detailed.

Unintended consequences

We encountered concerns about price formation and how that could become difficult especially in small- and mid-cap stocks as consensus earnings forecasts and fundamental research become less available. The possibility of growth in issuer-sponsored research in small- and mid-cap stocks (which could be more prone to issuer-bias) is concerning.

Overview of Sell-side respondent views

	Equities Research Management at Global Investment Bank	Small & Mid-Cap Equity Sell-side Analyst at Mid-size Brokerage	Business Head at Mid-size Sell-side Brokerage	High Yield Sell-side Credit Analyst at Mid-size Brokerage
Have you restructured your business because of MiFID2?	<p>No.</p> <ul style="list-style-type: none"> Firm has not reduced head-count or sought to cut costs by juniorising analysts Firm has changed the way their analysts work, sharpening their output on what clients value Producing less 'maintenance' research 	<p>Internally; not externally.</p> <ul style="list-style-type: none"> Prompted investment in a proper Research CRM. Research is now its own business with its own business plan rather than being wrapped up in Trading Buy-side & corporate clients will not notice much change Established rate card for Research business 	<p>Yes.</p> <ul style="list-style-type: none"> Firm has closed its sell-side equity research business and moved to an execution-only model 	<p>Yes.</p> <ul style="list-style-type: none"> Analysts have moved away from trading desks and no longer writing short sales notes & trade ideas Moved to longer, in-depth pieces which run via a supervisory analyst / compliance Written research still free, but clients must subscribe to service to get analyst time

	Equities Research Management at Global Investment Bank	Small & Mid-Cap Equity Sell-side Analyst at Mid-size Brokerage	Business Head at Mid-size Sell-side Brokerage	High Yield Sell-side Credit Analyst at Mid-size Brokerage
Has MiFID2 increased your cost base?	Yes. <ul style="list-style-type: none"> We had to introduce a number of new back-office systems & staff 	No.	No. <ul style="list-style-type: none"> It has reduced as firm closed its sell-side equity research 	Yes. <ul style="list-style-type: none"> Firm has hired a supervisory analyst and invested in compliance systems
Has MiFID2 impacted your revenues?	Yes. <ul style="list-style-type: none"> It has exacerbated a secular trend of falling equity trading revenues 	Yes. <ul style="list-style-type: none"> Write issuer-sponsored equity research Have seen increase in # of companies covered and fees paid 	Too early to say. <ul style="list-style-type: none"> Firm is winning more execution-only business, but have lost the research share of commissions 	Yes. <ul style="list-style-type: none"> Clients pay \$10k.p.a. for access to all research and analysts. This is new income
Has your coverage of companies reduced?	No. <ul style="list-style-type: none"> We have maintained our footprint and are looking at investment in small- & mid-caps 	No. <ul style="list-style-type: none"> It has increased in certain sectors. More issuers want to pay to get their story told 	Yes. <ul style="list-style-type: none"> We no longer provide any coverage 	Not really, but more time spent on writing than before and so fewer situations covered
Did you incur significant costs to implement MiFID2?	Yes. <ul style="list-style-type: none"> A significant sum and investment in systems is still on-going 	Yes. <ul style="list-style-type: none"> The up-front investment in the CRM system 	The execution only platform was a new business and received a significant investment in systems and marketing	Yes. <ul style="list-style-type: none"> The compliance systems and supervisory analyst hire
What are the Unintended consequences you see from MiFID2?	<ul style="list-style-type: none"> Created a competitive advantage for the large asset managers Growth in issuer-sponsored research in small- & mid-caps which is not independent Fee negotiations resulted in an underpricing of the written product/the research platform. As a result, analysts now produce less written content and focus more on phone & meeting contact 	<ul style="list-style-type: none"> Some small and mid-sized companies are struggling to get coverage. In some cases, even house brokers have stopped publishing 	<ul style="list-style-type: none"> Buy-side lost other soft-dollar services besides research and still depend on these Small active buy-side firms still need research and soft-dollar services and so suffering competitively compared to the big firms which have the in-house research and technical system support teams We will see increasing consolidation of mid-sized buy-side firms / fewer new entrants 	<ul style="list-style-type: none"> Clients don't call as much and are wary of taking cold calls, even when they are subscribers to the research service as they know this is a monitored cost Firm has to be careful about distributing US research for free into Europe Practices are less entrepreneurial and more bureaucratic/compliance-driven



Denotes negative response



Denotes positive response



Denotes neutral response

The Buy-Side View

We interviewed a large asset owner, two mid-tier global asset managers and one European asset management boutique which ran conviction strategy funds.

Restructuring

None of the firms we interviewed had any real need to restructure their organization or headcount. The larger firms reported a few new analysts being added here and there, but certainly no evidence of there being wholesale movement of analysts to buy-side. FICC and Equities required different responses: FICC had to set up new systems, rate cards and monitoring tools; in contrast Equities was able to carry on largely as before.

Revenues/Costs

In the case of the asset owner, the client pays for the services of the 100%-owned asset manager which absorbs all research procurement costs. Otherwise, all of the firms we interviewed had chosen to absorb the costs of buying research and not passed it onto clients. In the case of the asset owner (which was already unbundled) and the asset management boutique (which did not procure research or corporate access) this did not actually impact either their P&L or their client's returns. For the larger asset managers (which did procure sell-side research), this led to increased costs for them and net savings for their clients.

Apart from the boutique (not procuring external research) all firms reported savings in equity research and increases in FICC research

and corporate access costs. Generally, the savings in equity research more than off-set the increased costs elsewhere. All firms we interviewed were active managers, for whom research was important, but they noted that the impact of the reforms on passive asset managers was much less. The asset owner noted a reduction in trading commissions also as a result of unbundling.

Coverage & Quality

Opinion was divided on whether the quality of research had been positively or negatively impacted and whether coverage had reduced. The asset owner said it had been unaffected, whereas the two asset managers procuring research had said that coverage and quality had both dropped; they had also scaled back their broker lists slightly, though not to the extent they had anticipated at the start of the process.

Contact & Corporate Access

The two large asset managers reported an increase in direct corporate access and reduced contact with the sell-side. The asset owner and boutique reported no change – the boutique continuing to source its own corporate access and the asset owner starting to pay for access via the sell-side, though perhaps on a reduced basis now as they were having to pay for it.

Unintended Consequences

Interviewees' main concern in the long-term lay in the increasing consolidation of the industry which was regarded as a secular trend that MiFID II was only going to accelerate by disproportionately loading costs on the smaller firms.

Overview of Buy-side respondent views

	Global Head of Credit Research at Asset Manager (c.\$390bn AUM)	European Head of Credit Research at Asset Manager (c.\$425bn AUM)	Senior Equity Analyst at European Asset Management Boutique	Compliance Officer at Large Global Asset Owner
Have you restructured your business because of MiFID2?	<i>No. No increase in analyst headcount or production of research in-house in either credit or equities. Rather than rely on sell-side firms for corporate access, the firm now expects their credit analysts to get direct access & leverage equity research colleagues</i>	<i>No. Firm has paid a few selected analyst hires in equities. Fixed income has stayed the same Analysts now encouraged to turn down corporate meetings arranged by brokers</i>	<i>No. Our model has always been to mostly conduct all research internally. We have never consumed sell-side research other than from 1-2 strategic partners</i>	<i>No. Our firm unbundled research from trading (though not corporate access) in 2006 and so MiFID2 relatively meant less change for us compared to other buy-side firms.</i>

	Global Head of Credit Research at Asset Manager (c.\$390bn AUM)	European Head of Credit Research at Asset Manager (c.\$425bn AUM)	Senior Equity Analyst at European Asset Management Boutique	Compliance Officer at Large Global Asset Owner
Has MiFID2 increased your cost base?	Yes. Pre-MiFID II, firm did not pay for sell-side research. The firm negotiated fixed prices for access to all written research (on websites) and access to analysts and brokers on their A-list of providers	Yes. Pre-MiFID II, firm did not pay for credit research. Cost was assumed to be in the bid-offer spread. However, bid-offer spreads have not changed after MiFID II implemented. Suggests cost was never actually included in the first place	No. We have not added additional analyst resource; we did not rely on sell-side research previously to any great extent. Our investment style is characterized by a long-term, high conviction approach with fairly concentrated portfolios	Very slightly. We hired a Director to implement and oversee the reforms and are looking to hire an analyst to deal with all the data of procurement. We made savings on Equity research, but pay more now for Fixed Income and Corporate Access
Has MiFID2 impacted your revenues?	No. No impact on revenues. Whilst the firm has absorbed 100% of the cost of research, the incremental cost is within tolerance	No. Clients have not been billed for the research cost	No. Client revenues have been unaffected	Not really. The ultimate client has had to bear the increased cost of the two additional head-counts, but that is minor in the scheme of things
Has the sell-side coverage of companies reduced?	Yes. Research coverage has declined. Most noticeable for single-bond high-yield issuers. Some credits are "orphaned" – without any active sell-side coverage. Some equity brokers have sent formal notifications of securities they are ceasing to cover; in Fixed Income, coverage tends to quietly cease	Yes overall. Though there are pockets of the market where it may have increased. In Fixed Income the greatest rate of attrition has been in the low-alpha sectors (e.g. Utilities) where analysts can add least value	We believe so (in European Equities), but the reduction has not affected us	Not that has affected us. We continue to get all the research that we need
Did you incur significant costs to implement MiFID2?	Yes. Firm spent a lot of time cataloguing credit research needs, vetting existing providers and negotiating prices for research and corporate access. Also established a standards rate card for research services	Yes. Equities had a rate card and a commission system but all new to fixed income so incurred a lot of cost in management time to implement	No. The only real change was to ensure that we did not inadvertently receive and use research that we had not paid for. We used to get a lot of free research and did not have to worry about inducement rules (but now we do)	Yes. The two additional head-count and to ensure we were compliant we hired in a firm of external consultants. The implementation also absorbed a lot of management time
What are the Unintended consequences you see from MiFID2?	<ul style="list-style-type: none"> Quality of sell-side credit research has reduced Reduced coverage of single-issue high yield securities 	<ul style="list-style-type: none"> Reduction in coverage More group-think. More senior analysts have left research desks 	<ul style="list-style-type: none"> Possible concerns regarding price discovery in the small and mid-sized cap stocks 	<ul style="list-style-type: none"> The main consequence for the firm is the increased discipline that has been brought to research and corporate access procurement



Denotes negative response



Denotes positive response



Denotes neutral response

Independent Research Firm View

A core objective of MiFID II was to bring transparency to the pricing of investment research. One of the anticipated benefits of such transparency was increased visibility and market share of independent research firms. At the outset, MiFID II seemed like a step in the right direction. It prompted asset managers to consider what their actual research needs were and to modify their broker selection processes accordingly. This in turn created an opportunity for independent research firms to differentiate themselves and to efficiently target their marketing.

However, MiFID II has caused the buy-side to justify all research expenditure and not just sell-side research expenditure and this has been against a background of falling research costs. As different investment teams now must compete for their share of the overall research budget, many buy-side firms have reorganised to procure the research within a centralised finance team and away from the investment teams. This has meant in some cases that the decision to procure independent research (which is often very specialised) is no longer made by the specialist investor that will use it but by a centralised purchaser whom it is harder to persuade. They might also be more easily persuaded of the value of research from a sell-side provider that adds a "little value to a lot of people in their firm" rather than an independent in-depth piece which adds a lot of value but to only one user. Generally, this year the margins for Independent Research firms have not increased and indeed in some cases have fallen.

Furthermore, Independent Researchers have observed that buy-side analysts are pressured into overestimating their capabilities to produce research in an effort to control costs. In most firms the decision to purchase research has moved from the Investment Department to the Finance Department. This could have consequences for their investment decision making.

The continued supply of free research by market participants who are not in scope of MiFID II has continued to undercut Independent Research Firms' offering. Examples of such market participants include: banks, advisors, consultants, ratings agencies and issuer-sponsored research companies.

One area where the MiFID II regulation could have been clearer is on the extent to which research providers with no trading operations are allowed to provide research and related services free of charge. Some argue they should be allowed to because giving out free research cannot possibly be construed as an inducement to trade when the research firm has no trading arm. The FCA has tried to provide some informal guidance around this by saying that their application of sanctions on breaches of MiFID II regulations will be proportionate and that asset managers need not worry about taking a few meetings and research samples from independents if they have no trading operations. However, many asset managers would rather not take any risks and so do not accept any free research, even trial periods.

Finally, MiFID II appears to have resulted in reduced sell-side coverage of small- to mid-cap issuers and this is expected to lead to a rise in issuer-paid research to close the gap. There are lingering concerns and skepticism about the integrity and objectivity of issuer-paid research and that it may effectively morph into corporate marketing and what is arguably worse is that it is freely available, even to retail investors. Ultimately, issuer-paid research is likely to further marginalise the market for Independent Research firms.

Corporate Investor Relations View

Although the drivers for MiFID II Unbundling research were about the buy-side and sell-side, corporates have not escaped the impact of this regulation.

Since implementation, a majority of corporates have experienced a decrease in sell-side analyst coverage, with many analysts moving into roles in Investor Relations or Corporate Strategy Development. Consequently, small caps have had to either increase or build internal investor relations teams or hire third party providers to close the coverage gap. Mega caps on the other hand have welcomed the reduction in coverage as it has allowed them to deepen their relationships with the buy-side directly.

Whilst there has been a decrease in analyst coverage, most corporates have not experienced a negative impact on their businesses. This is attributable to Investor Relations teams stepping up their communications efforts by updating corporate websites and targeting investors. Furthermore, there are a wide variety of corporate access platforms available to issuers and offering various levels of capabilities and features like: institutional targeting and analysis, road show planning, investor profiles investor feedback and stakeholder interaction. Most report no need to increase their budgets, but the jury is out as to whether that is sustainable long-term.

Another consequence of MiFID II has been the increased demand for direct corporate access by investors. Since implementation, many investors are choosing to arrange all meetings with corporates directly as those organised by the sell-side now have to be paid for. Similarly, fund managers are increasingly providing feedback directly to corporates. The closer relationship between corporates and certain buy-side firms has resulted in better quality but possibly more concentrated feedback to boards of Directors and executive teams.

Attendance at broker conferences is declining as investors are now required to pay for access. In addition, restrictions imposed by MiFID II on brokers have resulted in mis-matches between the investor targets held by corporates and the catalogue of investors that brokers are able to invite to conferences. Corporates consequently have had to re-direct more internal resources to investor targeting.

Finally, in the wake of MiFID II implementation, it has become increasingly difficult to obtain accurate earnings consensus data about corporates on third party aggregators' platforms as many sell-side research notes now lie behind a paywall. Consequently, corporates are having to take greater control of gathering and managing consensus. Where sell-side analyst coverage is lacking, small caps may have to consider issuing market guidance on key metrics.

Overview of Independent Analysts & Corporate respondent views

	Head of Corporate Access at Small Bio-tech Corporate Finance Firm	Independent Pharma Fundamental Analyst at Sole Trading Company	Head of Investor Relations at FTSE-50 Corporate	Chief Executive of Investor Relations Society
Have you restructured your business because of MiFID2?	<i>No. Our firm was set up in 2015 with the MiFID II reforms in mind</i>	<i>No. Sole trading business continuing to operate with same business model</i>	<i>No. We have contracted with one new corporate access firm specializing in small investors</i>	<i>Small caps have either had to increase IR resource or hire third party providers to meet buy-side demand for direct corporate access. Mega caps have generally managed with existing resources</i>
Has MiFID2 increased your cost base?	<i>No. We have not yet added to our analyst headcount (12 total)</i>	<i>No. No significant changes to cost base</i>	<i>No, even though we run a small team (Head, PA and 40% of a Finance headcount)</i>	<i>Post-implementation, many investors are seeking to arrange all meetings with corporates themselves. This has increased demand on IR management time. To mitigate the effects of reduced sell-side coverage, corporate IR teams have become more strategic about their communications with investors. This has led to some investment in or subscription to new systems and so increased costs and demands on management time</i>
Has MiFID2 impacted your revenues?	<i>No to the contrary - we are acquiring new mid- and small corporate clients as the sell-side is ceasing to cover them adequately</i>	<i>No. Analyst has not changed her pricing structure for either off-the-shelf or bespoke work Analyst is hopeful that the MiFID II requirement for separate budgets for corporate access and research will expand the market for independent research</i>	<i>No</i>	<i>No. All members in a recent IR Society survey who have experienced a decrease in analyst coverage said there had been no material impact on their businesses</i>

Overview of Independent Analysts & Corporate respondent views

	Head of Corporate Access at Small Bio-tech Corporate Finance Firm	Independent Pharma Fundamental Analyst at Sole Trading Company	Head of Investor Relations at FTSE-50 Corporate	Chief Executive of Investor Relations Society
Has your coverage of companies reduced?	No. We have increased the number of corporates we cover and we expect this to continue to grow as the sell-side contracts	Analyst has not significantly changed her coverage of companies. She may cover new names as bespoke work for individual clients	No. All the main ~20 analysts are still in place (though a few have switched firms. Research quality has not been noticeably impacted. We see less "deep-dive" research, but that is a deep-seated trend that started long before MiFID II came into force	Yes. Almost 60% of IR Society's FTSE 250 and small cap members surveyed have experienced a decrease in analyst coverage since implementation
Did you incur significant costs to implement MiFID2?	No additional costs, no. We set ourselves up to comply with MiFID II	Some ambiguity in MiFID II language has impacted ease of signing new research agreements	No	No significant costs. Though there was an indirect increase in costs
What are the Unintended consequences you see from MiFID2?	<p>Small and mid-sized corporate universe increasingly covered by issuer-sponsored research firms rather than sell-side. Research is therefore more biased to corporates</p> <p>Large corporates have the resources and teams to organize their own roadshows, small corporates do not so increasingly rely on independent IR companies. Inevitable that some costs have moved to corporates</p>	<p>The aim was to create a market for paid research, but this is undermined by the continuing widespread proliferation of free research from various sources:</p> <ul style="list-style-type: none"> • Issuer-paid research is free to the buy-side and flow of this is expected to increase; • Bank corporate arms and consultants provide free industry sector research to establish their credibility • Some sell-side firms only charge for analyst time. <p>FINTECH platforms have emerged to create a market for independent research accessible to all subscribers, but Bloomberg too deeply embedded</p>	Company now has to keep a live track of its own consensus earnings forecasts and cannot rely on the Bloomberg/Reuters figure like they used to as they now some banks are no longer contributing their figures	As most sell-side research notes and forecasts now lie behind a paywall, it is harder for aggregators to find consensus earnings forecasts and this could lead to more share price volatility around earnings announcements



Denotes negative response



Denotes positive response



Denotes neutral response

Product Governance – The Impact on Manufacturers & Distributors

The consistent picture amongst our interviewees on product governance was that there has been no significant change in business, product offering or strategy as a direct result of the product governance reforms of MiFID II. In fact, all firms reported only slight changes in their existing product governance processes. Our interviews included one vertically-integrated firm which mainly manufactured and sold its own products; one manufacturer which sold mainly via distributors and two "hybrids" which distributed third-party products as well as their own.

The two main areas of the MiFID II product governance reforms which received the most attention were: (i) the target market provisions and (ii) the specific requirements of the costs and charges reporting template – the European MiFID Template ("EMT").

Target Market Protections

In all cases firms already had procedures and processes in place to ensure that both/either (i) the products they manufactured were being distributed to appropriate investors and/or (ii) those third-party products which they distributed were being sold to suitable investors.

That said, all interviewees referred to these procedures and processes needing to be refined in order to make them MiFID II-compliant. In the case of the vertically-integrated firm, this amounted to not much more than ensuring their processes used the "language" of MiFID II; in the case of the other three interviewees it led to more significant change: be it an upgrade of internal systems or modifications to review processes for third-party manufacturers/distributors respectively. In some cases, these refinements were regarded positively, improving the rigour of compliance systems.

In responding to their due diligence questions, the manufacturer found that some distributors were wary of releasing what they deemed commercially-sensitive information around their client base. Manufacturers also found the volume of information they received from distributors as quite overwhelming. All parties reported a lack of consistency in the reporting from their manufacturers/distributors and some confusion at grass-roots about the precise interpretation of the regulation, especially in the case of non-EU counterparties. However, all were optimistic that progress was being made.

Costs & Charges

All firms agreed that the new disclosures on costs and charges meant that end-clients were now in a much better position to understand how much, who and what they paid for. In this sense, one of the key objectives of MiFID II had been met. However, no one was convinced that the end-client felt they were actually better off for it!

- One respondent likened the impact of the increased transparency requirements to booking a flight ticket with a premium airline versus a budget airline. With the premium airline, the client might get a clear price with all the

necessities included. With the budget airline, the client gets a transparent price i.e. a full breakdown of cost of flight ticket, baggage fees, airport check-in fees, booking fees, infant fees, fees to choose a seat, taxes etc. The end-result being that whilst the budget airline's costs are transparent, it is not necessarily clear since all the additional information makes it harder to quickly compare against the costs of other airlines.

- We also encountered significant concerns around the ambiguity and the wide-range of resulting interpretations of how certain transaction costs are calculated. In particular, clients are reported to be confused by the effect of the slippage cost calculations which have meant that some products have negative transaction costs. This has been a very practical issue for manufacturer in reporting slippage costs in relation to their Asian dealings where orders were commonly left overnight for execution the following morning.
- Fund of Funds was another area highlighted for its complexity in transaction costs reporting as this involves several levels of costs being absorbed for analysis. A problem is that each underlying fund may have chosen a slightly different interpretation of the regulation and hence reporting methodology.

Increased Costs & Administration

There are ongoing attempts to create an industry-wide standardized format for efficient data collection and analysis, organised by industry bodies. One organisation mentioned is the Tax Incentivised Savings Association ("TISA"), a UK-based, cross-industry forum that works with major product manufacturers and distributors to come up with standardized formats. Another more frequently cited example was the European Working Group (now renamed FinDatEx) which is working on the European MiFID Template ("EMT") that provides a template for Target Market reporting.

Some firms are using these industry standardised formats to send and receive data from their distributors. This often comes with some costs, as firms need to invest in technology (internal or external) to enable this. Other firms, especially those whose products are primarily sold in-house, have elected to use in-house formats.

Respondents raised concern around the increased administrative burden – not just on the company but also on the client. For example, one interviewee noted how clients in long-term products now receive quarterly statements which most tend not to read and those that do feel more anxiety about the short-term performance of their investments. Advisors have to spend more time reassuring such investors.

Conclusion

In conclusion, the firms we spoke to were fundamentally supportive of the aim of MiFID 2 product governance measures. None reported the need for a seismic shift in the way they ran their business, but all pointed to a significantly increased administrative burden to implement the measures and that this was still very much on-going as the industry grappled to consistently gather and report the massive amounts of new data required. Further

guidance from ESMA was needed in some areas and interviewees expected guidance to tighten over time, though for now, more examples in ESMA guidance would be useful.

As to whether the end-client has benefitted, most felt the jury was still out. MiFID II has resulted in improved visibility on product fees and could lead to better value-for-money conversations with clients. However, the ambiguity in some of the regulation and guidance and the resulting divergent reporting practices means that not all figures can be trusted and compared yet.

Overview of Product Governance respondent views

	Head of Product Governance at UK Wealth Management Business	Head of UK Product Governance at Global Asset Manager with AUM of c.\$900bn	Head of Compliance at Mid-Size Global Private Wealth Adviser with Asset Management arm	Head of Product Governance at Mid-size European Private Wealth & Asset Manager
Are you a Manufacturer or a Distributor of Asset Management products, or both?	<i>Both. Mostly only distribute our own products. Where we distribute third-party products, these go through rigorous internal tests</i>	<i>Primarily a manufacturer</i>	<i>Both. Product offering includes third-party funds as well as co-manufactured funds. Distribute mainly to HNW & ultra-HNW clients</i>	<i>Both. Product offering includes third-party funds as well as co-manufactured funds. Distribute to HNW & charity clients</i>
Have you restructured your business because of MiFID2 Product Governance?	<i>No. No major change in business model. Most of the MiFID II requirements were already being carried out by the firm, as part of its own internal processes</i>	<i>No. No major changes to business model due to MiFID II's enhanced product governance requirements</i>	<i>No. No fundamental changes to product strategy, either</i>	<i>No. No major change in the business model of the company as a result of MiFID II's product governance policies</i>
Has MiFID2 Product Governance increased your cost base?	<i>No significant increased costs due to MiFID2 Product governance. The requirement to send clients quarterly statements was the biggest cost impact, which we are absorbing</i>	<i>Yes. Some increase in costs due to additional compliance and due diligence requirements on distributors Up-front implementation costs quite significant</i>	<i>Yes. Significant amounts went into system solutions to automate target market check for trades. This has the benefit of removing the potential for operational errors. Higher costs on co-manufacturing funds</i>	<i>No major explicit cost increases, though significant soft costs incurred to ensure that firm meets the spirit and letter of the new MiFID II regulations. No major changes in product distribution – just lots more data to assimilate</i>
Are any cost increases being absorbed or passed on to customers?	<i>No costs relating to product governance are being passed on to clients</i>	<i>The firm has absorbed the cost increases as they are very difficult to quantify on a transaction basis</i>	<i>Costs generally absorbed by the business and existing teams. Impossible to quantify the real additional cost. There has also been an increased demand on senior management time</i>	<i>No significant direct costs, though the company has had to hire a data vendor for some functions (e.g. EMT templates etc.). The firm has absorbed these costs</i>
Has MiFID2 Product Governance impacted your revenues?	<i>No</i>	<i>Increased focus on costs and charges has led to an increase in our sales of lower cost index-based products</i>	<i>No significant change attributable to MiFID2 Product Governance</i>	<i>No</i>

Overview of Product Governance respondent views

	Head of Product Governance at UK Wealth Management Business	Head of UK Product Governance at Global Asset Manager with AUM of c.\$900bn	Head of Compliance at Mid-Size Global Private Wealth Adviser with Asset Management arm	Head of Product Governance at Mid-size European Private Wealth & Asset Manager
How has your product governance processes changed?	<i>Robust product governance processes already in place. Minor amendments made to properly align to language of MiFID II.</i>	<i>Firm extended UK practice to other European entities, so cross-border practices now a little more robust</i> <i>Most significant change is that firm now undertakes product review annually instead of every 15-24 months</i>	<i>Product committees are more robust and front-office staff more involved in product governance process</i> <i>Implementation uncovered some procedures that were less robust and systems have been adapted to embed automated target market controls</i>	<i>Firm already had regular catch-up sessions with distributors. Product governance requirements (specifically target market) have now been added to the agenda for these meetings to provide a regular feedback loop</i>
Has there been a significant change to your product offering to any particular client groups?	<i>No</i>	<i>No. Increased focus on costs and charges has led to an increase in demand for lower cost index-based products</i>	<i>No products have been totally withdrawn or pulled from individual markets as a result of MiFID2</i>	<i>No</i>
What are the unintended consequences you see from MiFID2?	<i>Longer client consultation times and/or a risk that advisers get side-tracked into explaining some of the detailed charges information, for example negative transaction costs. This detracts from more important conversations about things like risk factors, asset allocation etc</i>	<i>Slippage costs - especially on Asian orders left overnight and so more exposed to market moves</i> <i>Second working group on EMT very necessary</i> <i>Distributors are wary of giving us commercially sensitive information</i>	<i>Non-EU manufacturers have been less familiar with MiFID II regulation. Getting costs and charges data in the right format from our non-EU manufacturers has been a challenge in some cases</i>	<i>Some distributors struggle with the new requirements as they are not yet familiar with it and there is no consistency in interpretation yet</i> <i>Manufacturers outside of the EU especially an issue</i>



Denotes negative response



Denotes positive response



Denotes neutral response

Expectations of Future Developments

As early as September 2018, just 9 months after the MiFID II implementation date, Dr. Kay Swinburn, MEP, and one of the key architects of the MiFID II regulation, gave the concept of a MiFID III a public airing. There is already a relatively long-list of aspects of the MiFID II which some industry participants would like ESMA to either (i) reverse (ii) amend; (iii) strengthen and/or (iv) clarify. Much as the industry will grind its teeth at the prospect of this after such a short period following the implementation of MiFID II, some form of further consultation and regulation does seem inevitable. However, there are genuine practical considerations about how soon, how broad and how deep the next iteration of MiFID regulation can be.

Product Governance

In the realm of Product Governance, the FCA has already published the findings of its review of 50 firms' reporting of costs and charges under the new MiFID II rules⁴. Whilst some good practice was highlighted, there were clearly areas where firms reviewed (and their partners/data providers) had fallen short of expectations. Some of the issues highlighted will take a considerable amount of time for those firms (and their partners/data providers) to work through, yet the FCA has been clear about its expectations in this area.

Research Unbundling

In the realm of Research Unbundling, the FCA's immediate assessment of the MiFID II reforms appears to be more positive. End-clients are being spared £180 million per year of annual charges – that is known; meanwhile the reported downside impacts of this impact of the regulation are, as yet, largely based on unproven fears about possible long-term consequences. Against this back-drop we suspect that very little will change, other than perhaps the issuance of some further clarifications in detailed areas such as how the inducement rules work for research providers that do not offer trade execution.

One big question that remains is what will happen in the United States – the world's largest capital market. In many respects, life would be simpler with one set of global rules, but the precedent for this being achieved is not encouraging. There are many significant areas of regulation – e.g. competition and insider trading laws – where EU and US rules are misaligned. With an eye on the cost-savings, some US investors argue in favour of the reform and the SEC appears sympathetic. However, the SEC's ability to introduce such a wide-sweeping reform through regulation alone and without primary legislation is constrained and there appears to be insufficient support amongst legislators.

So, in research, it looks like interested stakeholders will continue to have to hold a watching brief for a few years yet and we will eventually see if our concerns about the quality of small cap research and the sustainability of small buy- and sell-side firms will be realised.

⁴ <https://www.fca.org.uk/publications/multi-firm-reviews/mifid-ii-costs-and-charges-disclosures-review-findings>

Appendix: Further Reading

Relevant previous CFA UK publications

The challenges of regulations (August 2017)

<https://www.cfauk.org/professionalism/articles/the-changes-of-regulations>

Response to CP MiFID II implementation – consultation III (January 2016)

<https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-fca-consultation-cp1629.pdf?la=en&hash=B3A4EDC8E704A3B3A04C0CBF232F19F9C555867D>

Relevant previous CFA Institute publications

MiFID II: A new paradigm for investment research (November 2017)

https://www.cfainstitute.org/-/media/documents/support/advocacy/mifid_ii_new-paradigm-for-research-report.ashx

MiFID II: One year on: Assessing the market for investment research (February 2019)

<https://www.cfainstitute.org/en/research/survey-reports/mifid-ii-one-year-on>

Regulator web-sites

MiFID II: European Securities & Market Authority (ESMA)

<https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir>

MiFID II: Financial Conduct Authority (FCA)

<https://www.fca.org.uk/markets/mifid-ii>

Andrew Bailey keynote speech on MiFID II at the European Independent Research Providers Association (25 February 2019)

<https://www.fca.org.uk/news/speeches/andrew-bailey-keynote-speech-mifid-ii-european-independent-research-providers-association>

FCA MiFID II cost & charges review findings (28 February 2019)

<https://www.fca.org.uk/publications/multi-firm-reviews/mifid-ii-costs-and-charges-disclosures-review-findings>

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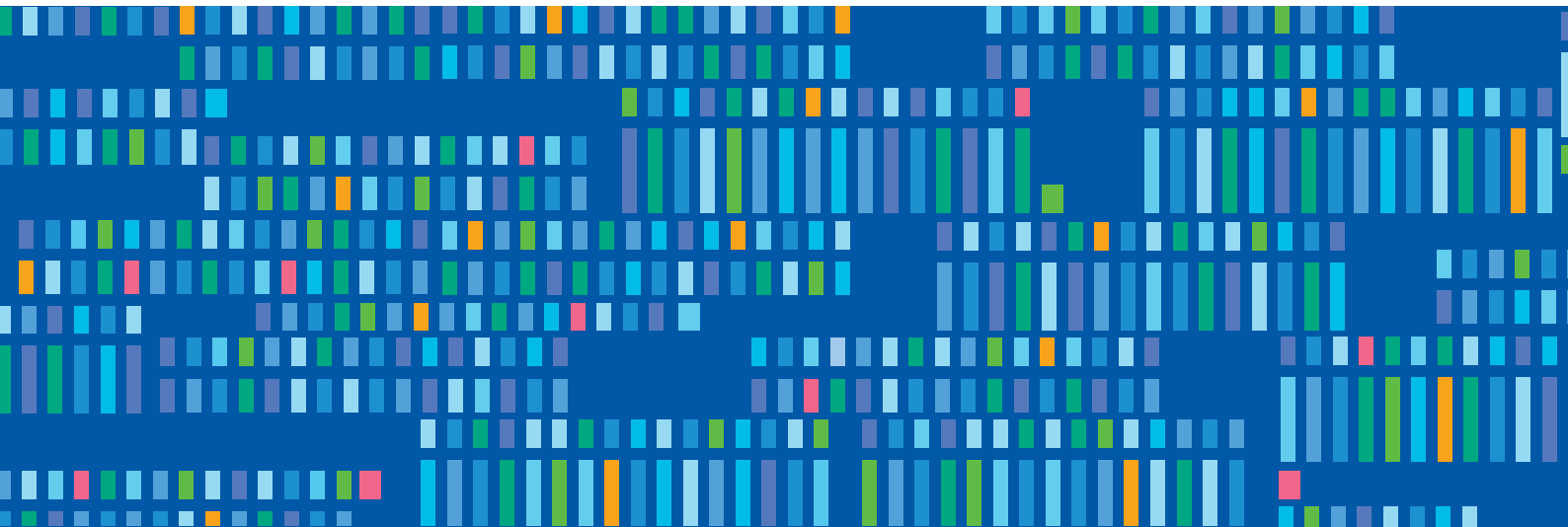
4th Floor Minster House

42 Mincing Lane

London EC3R 7AE

info@cfauk.org

www.cfauk.org



www.cfauk.org