MiFID II Research Budgets:
Active Management's "Big Bet"

Managers planning to use client money for research must submit proposed MiFID II research budgets to clients by Jan. 3, 2018. Asset owners must approve these for managers to continue to use client money for research.

This is an inflection point for the industry, with unknown outcomes taking place against a backdrop of evolving competitive conditions. Some managers are paying for research via P&L, while at the other extreme at least one manager using client money intends to distribute MiFID II budgets to all clients globally (BNP Asset Management). The vast majority (at this point) are somewhere between the two.

One thing is clear: Asset managers that have their proposed research budgets rejected by asset owners will end up paying for research via P&L – *involuntarily.* This is a bad outcome on several levels:

a) Managers will have to suddenly re-calibrate research spending both internally (negotiating research budgets with the CFO) and externally, as they may have to re-structure agreements made with research providers that assumed the use of client money.

b) Managers may be less profitable, and may have less research spending flexibility, which can erode returns and competitive positioning.

Given the stakes involved, managers should have paid a great deal of attention to maximizing the probability of client budget approval. Central to this will be the manager's ability to demonstrate to asset owners that their research spending supports their client's investment objectives – by aligning the research budget to the agreed investment process.

Curiously, this seems to be an afterthought at many managers. Senior management have devolved critical MiFID II decisions to mid-level operating committees, who are focussed on checklists of requirements rather than making important client-facing policy decisions. Most of the emphasis has been on getting the CSA/RPA payment mechanism to operate rather than to think about how to create research budgets that asset owners are likely to approve.

This has the appearance of an avoidable slow-motion train wreck for the active asset management industry. Managers are inherently (and perhaps unconsciously) betting that:

a) Regulators are not serious about MiFID II

b) Asset owners will have no interest in how ~$15 billion of their money is spent annually on research (despite universally conducting Trade Cost Analysis)

By January, European asset owners will be deluged by incoming (specific) research budgets from all of their MiFID II managers, some of whom will be running similar mandates but may have very dissimilar research budget requests.

For US pension trustees, the moment they receive advice from a manager that money is going to be deducted from the account for research, it creates an immediate fiduciary responsibility to assess whether the request is reasonable.

BNP Asset Management's decision to release MiFID II research budgets to all its global clients, not just those covered by MiFID II, may be a competitive inflection point for the industry – one that may permanently alter the interface between asset owners and asset managers.

This will inevitably introduce significant fiduciary issues for asset owners. The obvious question will be, "How does this research spending compare to the asset owner's other managers – regardless their geographic location and local regulatory framework".

Historically, most asset managers have not even had ex-ante monetary research budgets at the firm level, let alone de-constructing them down to strategy or fund level and analyzing how much those individual strategies should pay based on research intensity.

MiFID II regulated managers will have to construct a framework of multi-asset class research strategy budgets across the firm that will allow research costs to be fairly allocated to clients and eliminate cross-subsidization.

All global firms subject to MiFID II that plan to use client money for research will have to decide whether to follow BNP's lead, or explain why not.

An additional complexity for asset managers is that they will have no idea of how their competitors will construct research budgets (strategy-level, fund-level, size of budget) particularly in similar products.

This raises key questions for asset managers subject to MiFID II that are planning to use client money for research (and those that compete with them). These include:

1. How will we assign potentially thousands of funds/products into strategy budgets that fairly reflect research use? (and who at the firm will do this?)
2. How will we determine the "research intensity" of each strategy budget to determine how large the research budget should be? (The size of the research budget must be communicated in advance to the asset owner).
3. How will we develop a "research valuation methodology" that can be explained to clients, both in terms of the size of the research budget and how we value unpriced research services from investment banks. (The methodology will have to extend beyond short term product consumption (documents/meetings) because they cannot be forecast a year in advance).
4. How can we align research budgets with specific investment processes/products agreed with clients and meet the MiFID II requirement of "demonstrating research value to the portfolio"?
5. How will we construct multi-asset class research budgets?
6. How will we find a solution for cross-subsidization and be able to prove this to clients and regulators as part of detailed ex-post MiFID II reporting requirements.
7. How (and when) will we develop the MiFID II required Written Research Valuation policy which explains how we value research and how we fairly divide research costs between clients.
8. How will we meet the FCA requirement of noting substantive research interactions without deluging our investment professionals in time-consuming bureaucracy?

Some firms have gone through extensive RFP processes to choose systems to help with MiFID II research challenges that have focussed primarily on the payment mechanism. With the benefit of 20/20 hindsight, some have been alarmed to discover that their new systems don't actually value research – the central requirement of the new regulation.

With only months before MiFID II, the manager suddenly realizes that they have made no progress in solving the (very challenging) issues of constructing research budgets, figuring out how much they should pay for research - and how to justify that to clients and regulators.

An asset manager's ability to explain how the proposed research budget will support the asset owner's investment objectives will be central to budget approval. The research valuation/budgeting methodology and its alignment with the investment process will be the key.

Few asset owners will approve MiFID II research budgets based solely on the slickness of the manager's CSA/RPA payment mechanism (they don't care) – particularly in the absence of a coherent explanation as to how the research budget was constructed and how that will benefit the client's portfolio.

For asset managers, whose raison d'etre is based on their ability to understand and forecast economic/structural change in industries, and value assets accordingly, this haphazard approach to the most important client relations event in generations lies somewhere between poor risk management and wilful denial.

At a time when passive managers are gaining market share, and active managers are having to work very hard to prove their value proposition, this is a big gamble.

Many firms lack a research valuation policy that can be clearly explained to clients. Their bet is, that when presented with MiFID II research budget proposals, no asset owner will ask "How did you come up with this budget number?"

Frost Consulting works with asset managers on research valuation/budgeting issues.

Frost**RB** is a software platform that allows managers to create customized MiFID II-compliant Multi-asset class research budgets that reflect the manager's specific investment processes.

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