FCA Warning Shot on Research Commissions –Policy/Systems Considerations

On March 3rd, the FCA issued a stark assessment of the UK asset management industry's compliance with current FCA rules (let alone MiFID II). In a survey of 17 firms, it said the "majority" were not meeting the regulator's expectations.

https://www.fca.org.uk/news/news-stories/firms-continue-fail-meet-our-expectations-use-dealing commission

This seems curious given 15 years of vigorous industry debate, significant media attention devoted to the topic, vast sums spent by managers on compliance, and the imminent arrival of MiFID II, which will be a watershed event for asset manager-asset owner relations.

Most of the failings related to research valuation and budgeting, which have been required by the FCA since July 2014, and are about to become much more stringent under MiFID II.

In general, there was a lack of a comprehensive approach to research valuation. Managers were not ensuring research services were "substantive" and placing an independent firm-specific value on those services, as required.

(As an aside, some market participants were hoping that the banks would rapidly move to menu pricing of research as a result of the MiFID II stipulation that research and execution services should be priced "separately". Rather pointedly, the FCA's November 2016 600 page MiFID II implementation guide, conspicuously failed to require the banks to menu price – and it could have.) Regardless, it remains the responsibility of asset managers to discreetly value unpriced research services if they want to use commission (or any form of client money) to buy them.

The FCA found that research budgets had in many cases not been de-linked to historic spending levels. Managers were not assessing how much research was required by different strategy budgets. The MiFID II requirement of informing clients of their portion of the manager's research budget in advance, must be based on the specific investment product(s) that the client owns. This requires strategy or fund level research budgeting, rather than firm level assessments. Clearly not all investment strategies require the same amount of research or size of research budget – consider a Japanese small-cap fund versus a global all-cap fund.

The FCA also took issue with traditional "Broker-Vote" methodologies which still dominate asset manager research commission allocation processes. It said that percentage-based votes did not value research services and were not acceptable.

The FCA noted that some managers were persisting in these behaviours and threatened to take further action.

It is becoming clear, that a robust research valuation and budgeting process generating a framework of coherent strategy-based budgets across the firm, and the discrete valuation of research services (at the strategy level) will be key factors in attaining regulatory approval. Research budgeting/valuation will also be the central element in asset owners approving initial MiFID II research proposals from asset managers.

Managers that can directly tie research budgets to specific client mandates (at a reasonable cost) will maximize the probability of asset owner budget approval. The stakes are very high as we estimate that the profitability of active equity strategies may decline by 30 – 60% if research costs were transferred from the asset manager to the asset owner.

In Europe, decisions governing research funding and the engagement approach to clients with initial MiFID II research budget proposals are the most critical competitive policy choices that asset managers will make in many years. Yet, in many cases, mid-level operating committees tasked with system selection are inadvertently making long-term, client-facing decisions. Payment systems, while obviously necessary, are essentially commodities, and are unlikely to influence asset owner MiFID II budget approvals.

The reflex operational instinct to identify a single (bundled) system that does everything is a significant threat to manager profitability if it requires the use of sub-optimal research valuation/budgeting processes that risk clients' rejecting the manager's initial MiFID II research budget proposals and regulatory sanctions – risks embraced for the sake of short-term middle office operational convenience. (FrostRB's ability to export budget data to any CSA/RPA payment system solves the problem).

The key questions are a) whether your current/prospective solution meets the FCA tests by creating a coherent firm-wide framework of strategy/fund research budgets that can value research services at the strategy level? and b) whether your research valuation system choice will ultimately support *or undermine* the firm's overall MiFID II client strategy (if it has been determined)

FrostRB *has answers.*