MiFID II: Considerations for U.S. Investment Managers

With less than five months until the implementation of MiFID II regulations, uncertainty abounds, and many U.S. managers find themselves with more questions than answers. Why should U.S. firms care about these European regulations? What impact will they have on our business? What, if anything, can we do to prepare? To help you prepare for what lies ahead, we share our findings and suggestions below.

What is MiFID II?

MiFID II is a progression of the Markets in Financial Instruments Directive (MiFID I), a set of 2007 European Union laws intended to harmonize investment service regulations across the European Economic Area. These laws were designed to improve the competitiveness of European financial markets and increase customer protections. However, in the aftermath of the 2008 financial crisis, the European Commission deemed it necessary to revise MiFID in order to prevent similar outcomes. These revisions, first published in 2014, are commonly referred to as "MiFID II." The new regulations, which officially go into effect January 3, 2018, will impact several aspects of investment services, including transaction reporting, best execution, product governance, trade transparency, and procurement of investment research.[1]

Why do European regulations matter to U.S. based firms?

While the primary targets of MiFID II are "investment service participants" located within the European Union (EU), U.S. investment managers should prepare to be impacted, either directly or indirectly, by many of these regulations. U.S. managers with EU-domiciled clients will be affected directly by MiFID II. Europe refers to these providers as "third-country firms," and imposes varying degrees of oversight depending on the sophistication of the provider's clients.

Even managers without EU clients, while technically outside the reach of MiFID II regulators, could face client and competitive pressure to comply with these regulations. For example, certain global clients may prefer the reporting and/or transparency they receive from their EU service providers, while others might simply find it too burdensome to apply different standards between their EU and U.S. branches. As a result, many U.S. managers may be forced to amend their operations to compete for this business.

What area of MiFID will have the greatest impact on our firm?

Based on our research and recent meetings with both European and U.S. firms, CAPIS expects the procurement of investment research using client commissions to be the portion of MiFID II most relevant to U.S. managers. As such, the remainder of this paper focuses on the rules related to investment research as well as potential issues raised by those rules – and recommends steps the U.S. should consider as the deadline for MiFID approaches.

Inducements

One of the primary goals of MiFID II is to prevent or manage conflicts of interest between investment managers and their clients. A particular area of concern is the potential conflict created when managers receive certain

[1] The practice of managers procuring investment research using client commissions is known in the U.S. as Client Commission Arrangements, or simply "soft dollar" payments. It is important to note that regulations related to this practice apply equally to both propriety and third-party research.

"inducements" from third parties. Most notably, these inducements include investment research purchased via dealing commissions. However, in lieu of banning the practice outright, MiFID II significantly modifies how research must be paid for and priced.

Research Payment Accounts

The new regulations allow affected managers to continue procuring investment research as long as it is paid for with one of the following methods:

- The firm's own resources (P&L model) or
- MiFID II compliant Research Payment Accounts (RPA)

The RPA is a ring-fenced account created and controlled by the manager to custody client assets meant to purchase research. To fund these accounts, managers have two options: 1) bill each client directly for an RPA contribution fee or 2) set up Commission Sharing Arrangements (CSAs) with their brokers and fund the RPA using a portion of execution commissions.

Our preliminary research suggests most managers plan to utilize the CSAs to fund their RPAs. While this method may carry a higher administrative burden (discussed below), many managers are already obtaining research using CSAs and believe the transition to an RPA model will be relatively simple. A smaller number of managers appear interested in funding the RPA by billing their clients directly. Although billing clients directly will likely require less administration than the CSA model, managers seem dissuaded by the idea of having to present clients with a separate research invoice in addition to their normal management fee. More managers will likely pay from their own P&L than use the client billing model.

Regardless of the funding option chosen, MiFID II requires managers to regularly budget for and assess the research purchased with RPA assets. Budgets must be set in advance and presented to clients in either the investment management agreement or the firm's general terms of business. Managers may not exceed these budgets unilaterally, and any proposed increase must be clearly reported to the client in advance.

The budgeted amount must be set based on the need for research and cannot be tied to client transaction volumes or values. Managers have some flexibility in setting the scope of the budget (per client, fund, strategy) and the duration of the budgeting period (quarterly, annually, etc.). At the end of the budgeting period, managers must report to each client the amount they paid into the RPA and, upon request, must provide a detailed description of the research purchased. Any RPA funds remaining at the end of the budgeting period must either be returned to the client or carried forward to the next period.

Managers must also provide clients with a written policy describing how they assesses the quality of the research purchased with RPA funds. At a minimum, firms should be prepared to demonstrate how the research purchased: 1) adds value, 2) represents original thought, and 3) presents meaningful conclusions that contribute to better investment decisions.

Unbundling Pricing

MiFID II also modifies how investment research must be priced. Whereas broker-dealers have traditionally bundled the price of their proprietary research into the cost of trade execution, MiFID II requires that research and execution services be priced separately.

Open questions related to investment research

Several questions remain open regarding how these regulations will be administered and how the industry will be impacted. Below we briefly highlight a number of these potential issues.

Research marketplace – The unbundling requirement is expected to significantly impact providers of investment research. For example, proprietary research brokers may determine they either cannot (see below) or, for profitability reasons, will not provide separately priced research products. This should give an advantage to independent providers who have historically priced their research separately, and increase providers in this space. On the other hand, RPA burdens by some managers, or the shift to P&L funding by others, will likely result in managers becoming more selective about the research they purchase. As a result, the amount of external research consumed may decrease significantly. In fact, some managers have already stated they intend to expand their internal research departments under MiFID II.

Principal transactions – It is also unclear how the RPA rules will apply to products that traditionally trade in a principal capacity. Under the CSA model, RPAs are funded with a portion of the execution commission paid to the broker. However, principal transactions involve broker remuneration embedded within the total cost of the transaction. As a result, it is unclear how managers will be able to fund RPAs with these types of products under MiFID II.

Budget participation – We also anticipate issues related to the requirement that clients agree to the RPA budget in advance. Managers will have to consider how they will address clients who refuse to contribute their portion of the budget. Will they be allowed a "free ride"? Will the client be fired? Will managers should separate trading between clients who contribute and those who do not? While there does not appear to be a consensus answer to this question, managers should prepare in advance to address this issue should it arise.

Conflict with U.S. regulations

U.S. investment managers attempting to strictly comply with the research portions of MiFID II are likely to be frustrated. Several requirements appear to be at odds with Section 28(e) of the Securities Exchange Act of 1934, meaning that compliance with MiFID II may trigger a violation of domestic securities laws.

- For example, under Section 28(e), research credits must be owned by and under the control of a registered broker dealer. MiFID II RPA accounts, on the other hand, must be under the control of the investment firm and can be held by a third-party RPA provider. Therefore, compliance with one set of regulations appears to violate the other.

- Another regulatory conflict relates to the procurement of proprietary broker research. As discussed above, MiFID II prohibits brokers from bundling their research with the cost of execution services. This will require affected brokers to explicitly price their research going forward. However, U.S. securities laws require brokers that separately bill for their research to register as investment advisors, a step many will resist due to increased fiduciary obligations. As a result, managers subject to MiFID II will be unable to purchase research from these brokers absent relief from regulators. This relief will likely need to come from Europe, as the SEC has already stated it does not intend to modify its regulations in response to conflicts with MiFID II.

"Substantially Equivalent" MiFID II compliance

While simultaneous compliance between MiFID II and U.S. securities laws may be impossible, a recent letter published by the Financial Conduct Authority[2] (FCA) seems to suggest that strict compliance with MiFID rules may not be required for most U.S. firms. The letter, dated July 19, 2017, addresses the issue of what level of MiFID II compliance the FCA expects from U.S. based firms acting as subadvisors for UK investment managers. Although the FCA states it will require an "equivalent level of protection" for EU clients regardless of where the services provider is located, it concedes that these protections may be provided…

[2] Letter from Stephen Hanks, Financial Conduct Authority, to Jiri Krol, Deputy CEO, AIMA (July 19, 2017).

"through other operational arrangements that are consistent with, but without necessarily being precisely the same as, the MiFID II provisions – as long as they achieve the same investor protection outcomes for their underlying clients."

In other words, it appears the FCA, in instances where a non-EU firm cannot abide by MiFID II without violating its own domestic regulations, will nevertheless permit that firm to service EU clients if they provide "substantially equivalent" compliance protections. As an example of substantial equivalence the FCA cites the proprietary research issue discussed above. According to the FCA's letter, they would ease MiFID II rules and permit a U.S. subadvisor to continue procuring research via a bundled commission payment as long as certain budgeting and accounting procedures were implemented.

It should be noted that the statements in the FCA letter apply only to UK regulators, and do not necessarily reflect the views of ESMA or other EU members. However, if the FCA's approach were adopted by ESMA, it could provide a means for U.S. firms to continue serving EU clients without violating domestic regulations, or requiring any rule modifications by the SEC.

Suggestions for "Substantial Equivalence"

Firms that subadvise for EU managers, or those with clients expecting MiFID type protections, should begin considering how they might achieve substantial equivalence with these research rules. The following is a list of steps managers could consider:

- Prepare an annual research budget covering affected clients
- Present the budget to clients in advance of the budget period
- If using CSAs, monitor trading and switch to execution-only commission rates once the budget is met
- Prepare written procedures to regularly assess the value of research purchased
- Create procedures to ensure receipt of research does not influence routing and best-ex decisions
- Provide clients with an annual report detailing their RPA contributions

At a minimum, CAPIS recommends managers be prepared to respond to clients enquiring about their MiFID II preparedness. Even if managers conclude these regulations are completely inapplicable to their firm, we suggest they be ready to explain these conclusions to their clients.

Final considerations

Despite continuous media coverage suggesting MiFID II will drastically change the industry, most U.S. firms are outside the reach of the EU regulators and are unlikely to experience any significant impact from these regulations. Nevertheless, it would be prudent for domestic managers to carefully consider the issues outlined above and begin discussions now with clients who have expressed MiFID II needs.

If you have any questions regarding this article, or would like additional information related to MiFID II, please contact the CAPIS compliance team at compliance@capis.com.

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