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MiFID II's Research Payments: State of play

Many asset managers would welcome further guidance into the new policies and procedures of MiFID II's research payment rules. Given this, a particular area of focus of the FCA's current review is expected to be the pricing of certain research packages by investment banks, and whether some of those packages could be considered to be an inducement to trade with those research providers.

Since January 2018 asset management firms should only pay a broker using trading commissions for trade execution services. Asset management firms will have chosen whether to pay for research themselves, or to unbundle their trading commissions and utilise a research payment account to segregate research monies. Either way, payments for research using commission should be budgeted in advance in the form of a monetary amount and not be determined as a basis points charge against trading costs.

Asset management firms who believe they are MiFID II–compliant in research payments will have put in place the systems and structures to ensure that the trading desk alone decides on when, where and at what cost to execute trades. Separately, investment professionals should exclusively determine value and pricing of research services.

However, post the MiFID II implementation deadline, **evidence suggests greatly differing implementation of the payment for research.** In the UK, the largest firms have put in place working parties to discuss MiFID II implementation and have decided to use their own money to pay for research services, therefore not passing the cost on to investors. In Europe, we find regulators who have not yet opined on the implementation of the research rules and industry participants who have yet to take the first steps towards the unbundling of trading commissions. Furthermore, it is also too early to know how each European regulator will interpret the rules in their own jurisdictions, if and how they will enforce the rules, and when that process will start.

A potential unintended consequence that could emerge is the **potential for cross-subsidisation of payments for research in execution trade commissions.** While processes may be built with the best of intentions and are seemingly robust, there are risks. The reality of the industry in 2018 is that the largest providers of trade execution services are also the largest providers of research services. Optimists believe that MiFID II will contribute a landscape where specialist, high quality providers of trading services and counterparts in the research services area will flourish in the future. But for now, the dominant players remain the global investment banks who have businesses in both trading services and research services and the resources to provide those services.

The subject of research price "discovery" was and is still arguably one of the hardest parts of MiFID II for the industry to tackle. Towards the end of 2017 the industry scrambled to tie up agreements for the cost of research services post MiFID II. This was a significant new challenge for all parties; from decades of "bundled" commissions paying for research and execution services (with some use of commission sharing arrangements (CSAs)", to a wholly "unbundled" model with separate pricing and payment models for execution and research. There were wildly differing prices as research providers tried to agree research pricing with customers, from low tens of thousands for basic level service access, to hundreds of thousands per annum for equivalent services. Eventually a small number of firms decided to make their core fixed income research "free to all". Others argued that this was against the "spirit" of the rules. Some asset managers pushed back, looking to pay more for a valuable service. Their concern was that regulators would consider the fees for research too low and wonder if the costs of research were being subsidised by other business transacted with the research providers, including potentially an "inducement" to trade. Some asset management firms acted as "price setters" (determining prices using their own methodology, for example interaction rate cards), others as "price takers" waiting for pricing models to be supplied by the research providers. It should be hoped that the FCA review will provide more guidance for the industry to enable more long-term consistency in pricing across the research market.

As the FCA contact firms, gather evidence and examine procedures our expectation is they will want to ensure that the research pricing model is sustainable. At IHS Markit we see asset management firms utilising our proprietary systems to evaluate and ensure best practice in quality and cost of both trade execution and research services. To us, that is **strong evidence of asset management firms wanting to pay a fair and sustainable price for a good quality product, whether they are using commissions or their own money to pay for those services.** Nevertheless, there is much work to do in consolidating research consumption, enhancing research evaluation and the formation of research price benchmarking data sets.

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