

Researching research costs

Mifid II will change the research landscape. Fund managers must consider how investment research should be priced as well as alternative data sources

2018 will usher in significant changes as to how research is provided and consumed across the European Union. The revised Markets in Financial Instruments Directive (Mifid II) will prohibit EU managers and EU independent advisers from receiving any third-party inducements (with the exception of minor non-monetary benefits). Managers and advisers will instead have to pay for investment research out of their own pockets or set up research payment accounts (RPAs) that are funded by their clients and from which research is subsequently paid.

Whilst there has already been much discussion regarding the complications arising from the use of RPAs and the possible decline in total research available should a portion of the sell-side decide to cease providing research altogether,

confusingly, recital 50 of the delegated act states that: *'Investment research should be a sub-category of the type of information defined as a recommendation in Regulation (EU) 596/2014 (market abuse)'* even though it may instead be more accurate to characterise recommendations as a sub-category of investment research (seeing as not all research amounts to a recommendation).

To add to the confusion, the exhaustive list of acceptable minor non-monetary benefits in the delegated act raises more questions than answers. The only acceptable minor non-monetary benefit capable of amounting to research is contained in article 11(3)(a) of the delegated act which refers to information *generic in nature or personalised to reflect the circumstances of an individual client*. Whilst it is an understandable boon for generic research to fall outside of scope of the

research needs to be paid for separately, seemingly capturing not just substantive pieces of written research but also access to research personnel that provide more than short term market commentary or notice of upcoming events, whether via electronic communication, calls, face-to-face meetings or otherwise.

Pricing models

Having established (broadly) what research must be paid for separately, the next question is at what price should such research be set? Little thought had previously gone into the value of research since the sell-side offered free research (amongst other services) to promote trade flow for their brokerage businesses and the buy-side (at least those in the UK) was permitted to receive free research provided that it was substantive.

Assuming managers and advisers still need or want to receive research from a third party then the price set has to be 'just right'; too high a price and managers and advisers won't pay (or, at least, won't continue to pay) but too low may render the business of research economically unviable.

Mifid II does not prescribe a particular pricing methodology for research. However, to prevent undermining the main legislative intention of unbundling research and execution costs, the directive prohibits the cost of research from being directly related to trade volume.

Of the options remaining, research providers could choose to price a particular research piece based upon the eventual profitability of the resultant investment. However, this would be fraught with difficulties since any payment for research would then be predicated on the investment making money (which may not always be the case) and there would still be hard, qualitative questions regarding what proportion of the profit generated from an investment should be attributable to the research and how research should be priced where it results in a loss being avoided. Further, Mifid II requires managers and advisers using an RPA to agree a research budget with their clients upfront which may be impossible to accurately calculate given the uncertainty with this pricing model.

Perhaps a more workable solution would be to adopt the model tried and tested by the legal profession – assigning a value to research based upon the experience of the researcher and the time spent. This pricing model would enable research providers to receive fair value as well as provide

Until a standard pricing practice emerges, pricing investment research will be tantamount to determining the length of a piece of string

stakeholders need to consider the value proposition for research from all sides of the table if they are ever able to find a sustainable model.

To determine the value of research, it is crucial to understand what 'research' means and, in particular, what type of research managers and advisers will have to start paying for separately.

The granular rules relevant to research and RPAs are contained in article 13 of the Mifid II delegated act on organisational requirements and operating conditions for investment firms and defined terms, which expressly refers to research by third parties.

Meaning of research

Mifid II does not contain a hard definition of what constitutes research. Rather

prohibition on receiving inducements, *information...personalised to reflect the circumstances of an individual client* seems to be exactly the type of benefit which the prohibition was designed to address.

Consequently, most managers and advisers are instead looking to recital 29 of the delegated act which lists as acceptable minor non-monetary benefits *short term market commentary on the latest economic statistics or company results and information on upcoming releases or events, which is provided by a third party and contains only a brief summary of its own opinion on such information that is not substantiated nor includes any substantive analysis* and interpreting article 11(3)(a) of the delegated act in this context.

This leaves a wide ambit for what

managers and advisers with greater flexibility to dictate the final work product and, as a corollary, a greater ability to manage their research costs. Alternatively, if a manager or adviser requires research of a particular nature where both its expectation and the provider's effort remain a constant, perhaps a fixed-fee could be agreed. This fixed-fee model may take the form of the provider levying charges per research piece or by the manager or adviser paying a monthly or a yearly subscription fee.

While the Financial Conduct Authority has indicated that it does not expect managers and advisers to pay for each piece of research separately, there is nothing prohibiting the adoption of this pricing model if the parties desire.

Until a standard pricing practice emerges, pricing investment research will be tantamount to determining the length of a piece of string.

Alternatives to purchasing conventional research

As the last piece of the puzzle when researching research costs (and, arguably, the most important) a manager or adviser should consider whether it would instead be simpler, cheaper or more effective to hire its own research staff or even to invest in technological solutions that may produce a similar outcome.

The advent of the internet has brought technological advances in information gathering and sorting which have already positively altered the research landscape and will continue to do so. Whilst historically managers and advisers have relied heavily on human effort to find and review (for example) a company's prospectuses, financial reports and other data to understand its business and financial prospects, information of this nature can now often be easily located

online or through other information portals.

It is an offence under the EU Market Abuse Regulation (MAR) for a person to disclose, or trade using, inside information that relates to a financial instrument admitted to trading on an EU trading venue or (where applicable) its issuer. Issuers are required to publicly disclose inside information as soon as possible other than in limited circumstances. Therefore, research providers theoretically have the same (and no greater) ability to access these source materials as other market participants. If a manager or adviser has neither the time nor inclination to find and sort through relevant information, there are now third party systems and programs that can perform these functions to various degrees.

Not only is technology in this area evolving, but the range of information that will be available to market participants will also be widening. Mifid II significantly expands the scope of financial instruments for which pre and post trade data will have to be published, requiring data to be published for equity, equity-like and non-equity financial instruments that are admitted to trading on any EU trading venue (not just for shares admitted to trading on a regulated market).

Additionally, since MAR is applicable to issuers of financial instruments admitted to trading on any EU trading venue (and not

just regulated markets), there are now more European issuers than before that are required to disclose inside information about themselves as well as transactions conducted in their securities by a person discharging managerial responsibilities.

Before making an assessment against their needs, managers and advisers should strongly consider the full range of information sources and information processors that are available to them including, but certainly not limited to, conventional research providers. The dynamic between technology and live information, and the advantages it brings, has already been capitalised by those in the market engaging in algorithmic trading.

Out of all this, there may also be a potential silver lining for managers and advisers. Generally, managers and advisers have been expected to pay for access to third party information portals (and, where already used, information processing software) themselves. However, as the line between research and data/technological solutions continues to blur, in certain instances it may be possible for managers and advisers to reduce their own costs by passing these charges onto clients where the manager or adviser can justify their payment using an RPA.

By Christopher Poon, counsel in Akin Gump Strauss Hauer & Feld's London office.

A manager or adviser should consider whether it would be more effective to hire its own research staff or even to invest in technology that may produce a similar outcome

IFLR
INTERNATIONAL FINANCIAL LAW REVIEW

• Banking • Regulatory • Corporate • Capital markets



Keep abreast of regulatory developments in the financial sector

Subscribe to IFLR today and enjoy:

- **News analysis** on international financial law, now including Bank Capital coverage, updated daily on IFLR.com;
- Behind the scenes explanation of **new deal structures** and the implications for your practice;
- **Exclusive insight from interviews** with senior regulators and policy makers;
- Regular **special focus supplements** on sectors, products and countries; and much more.



To **subscribe today** call Peter Sakwa on +44 (0)20 7779 8165 or contact peter.sakwa@euromoneyplc.com

This communication is from Euromoney Trading, a company registered in England and Wales under company number 954730 with registered office at 8 Boulevard Street, London, EC4V 3AX, UK.