CFA Institute

MIFID II: ONE YEAR ON

Assessing the Market for Investment Research

The mission of CFA Institute is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. CFA Institute, with more than 164,000 members worldwide, is the not-for-profit organization that awards the Chartered Financial Analyst® (CFA) and Certificate in Investment Performance Measurement® (CIPM) designations. CFA®, Chartered Financial Analyst®, AIMR-PPS®, and GIPS® are just a few of the trademarks owned by CFA Institute. To view a list of CFA Institute trademarks and the Guide for the Use of CFA Institute Marks, please visit our website at www.cfainstitute.org.

ISBN: 978-1-942713-66-1

Contents

Executive Summary

Since the introduction of MiFID II in January 2018, asset managers and investment banks have weathered a shakeout in the investment industry as investment firms seek to recalibrate their research needs under the new regime.

Although MiFID II has brought transparency and competition to the investment research business, a Europe-wide survey by CFA Institute on the outcomes of MiFID II one year on paints a picture of reduced research budgets and rising concerns over a perceived reduction in research quality and coverage.

With indications that buy-side firms are in-sourcing research, pressure is mounting on independent and sell-side research providers. The investment professionals surveyed cite decreases in the number of analyst jobs and a scaling back of research coverage, with the small- and mid-cap equity sectors affected most.

Key Findings

- Independent research providers have not benefitted from MiFID II. A more competitive research marketplace is squeezing research providers; in particular, 57% of buy-side respondents report sourcing less research from investment banks than before MiFID II, and most respondents cite a reduction in sell-side analyst jobs.
- Research budgets have been scaled back, with the largest firms making the biggest budget reductions. Although the survey finds an average 6.3% decrease in research budgets, it also finds that budget reductions increase with firm size: for firms managing more than €250 billion in assets, the average budget reduction is 11%; for firms managing less than €1 billion in assets, the budget change is negligible.
- Buy-side professionals mostly believe that research quality is unchanged, but sell-side respondents are generally more pessimistic, with 44% believing that research quality has decreased overall. Significantly, a relative majority of sell-side respondents (44%) believe the research quality of small- and mid-cap stocks has decreased. Less than 10% of both buy-side and sell-side respondents believe research quality has increased.
- Survey respondents also express concerns over research coverage, with 47% of buy-side respondents and 53% of sell-side respondents reporting a decrease in coverage of small- and mid-cap stocks.
- Overall, however, 39% of respondents believe the research marketplace is more competitive, compared with 25% who believe the research market is less competitive.

1. Introduction

The European financial services industry underwent its biggest regulatory overhaul in more than a decade with the introduction of the revised Markets in Financial Instruments Directive (MiFID II) on 3 January 2018. The legislative package introduced significant changes to investment firms and financial markets, including enhanced "inducements" rules governing the payment for investment research.

Additionally, MiFID II introduced new trade-transparency requirements in equity and fixed-income markets, strengthened requirements for the provision of investment advice, and enacted new product governance rules.

Most notably, the changes to portfolio management inducements rules disrupted the provision of investment research. Under MiFID II, providers of research, such as investment banks and brokers, are required to set prices and charge for research separately from trading costs (commissions and spreads). Investment management firms—users of research—have had to determine whether to absorb the cost of research or to pass on those costs to clients. The changes broke the historical business model of investment firms bundling research with transaction costs, which are deducted from the client's account.

The motivation for introducing these rules was to alleviate potential conflicts of interest between investment managers and their clients when transacting with brokers. The provision of supplementary research services by the executing broker—such as research reports, analyst calls, corporate access, or other nonmonetary benefits—creates incentives to route trades to that broker. These so-called inducements may create the potential to trade more often than is appropriate for the client or to preclude the use of other brokers who may provide more favourable execution services. Consequently, end-clients may incur higher (bundled) transaction costs than would otherwise be appropriate.

With the implementation of these changes, the nascent market for investment research has undergone a period of price discovery, with research providers seeking to establish prices for different research products and services, and investment managers developing research budgets that align more explicitly with the investment strategy being pursued. A key business decision for investment managers has been to determine whether to pay for costs internally (against the firm's profit and loss) or to pass costs on to clients (by way of a research payment account). As investment managers have calibrated their budgets, research providers have had to adjust pricing estimates and consider the scope of coverage across asset classes, sectors, and geographies.

One year on from the introduction of MiFID II, CFA Institute sought to assess the state of the research marketplace through a survey of investment professionals. We set out to gauge the industry's perceptions of the impact of the rules on research budgets, costs, quality, coverage, and other aspects.

This survey builds on a CFA Institute survey report of buy-side investment professionals published one year ago,[1] enabling a comparison of market expectations before the introduction of MiFID II with perceptions of the research marketplace one year into the new regime. This survey also builds on prior work by incorporating the view of sell-side professionals in addition to buy-side professionals.

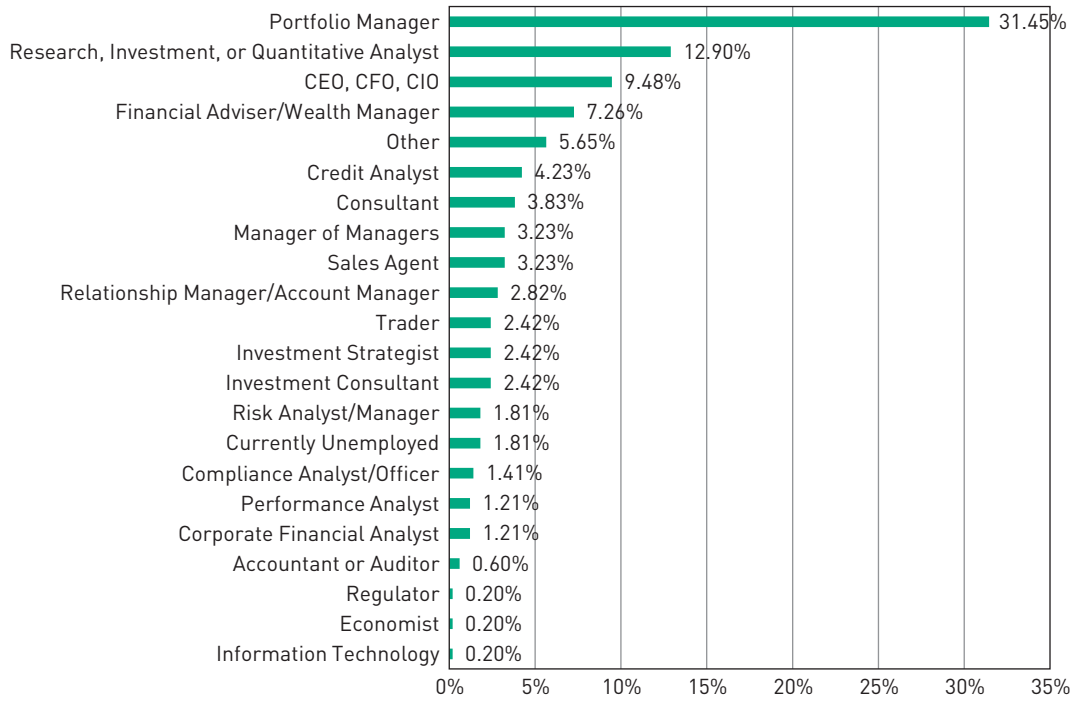
[1] *See* Rhodri Preece, *MiFID II: A New Paradigm for Investment Research,* CFA Institute (2017), www.cfainstitute.org/en/research/survey-reports/mifid-ii-a-new-paradigm-for-investment-research.

2. Survey Methodology and Demographics

CFA Institute conducted a survey of its European members between 6 and 19 December 2018. We sent the survey to a sample of 12,633 members in the European Union, the United Kingdom, and Switzerland. In total, 496 responses were received, for a response rate of 4% and a margin of error of ±4.3%. Respondents came from 449 different firms across 25 different European countries.

Figure 1 illustrates the respondent profile by occupation. The top four occupation categories represented are portfolio manager; research, investment, or quantitative analyst;

FIGURE 1. RESPONDENT PROFILE BY OCCUPATION



Note: Percentages are rounded.

C-suite (chief executive officer [CEO], chief financial officer [CFO], chief investment officer [CIO]); and financial adviser/wealth manager. Collectively, these core investment management job functions account for 60% of respondents.

Figure 2 illustrates the respondent profile by type of firm. Approximately 60% of the respondents work in asset management or private wealth management firms, and nearly 25% of respondents work in banking institutions. In total, approximately two-thirds of the respondents (68%) work on the buy side of the investment industry, and one-fifth (20%) work on the sell side.

Figures 3A and **Figure 3B** show the assets under management (AUM) of buy-side respondents' firms. The data illustrate that a broad cross-section of firms across all size categories are represented in the survey results (Figure 3A). We subsequently grouped responses into four AUM categories, with a similar mass of respondents in each category, to enable statistically significant comparisons across firm size (Figure 3B).

FIGURE 2. RESPONDENT PROFILE BY TYPE OF FIRM

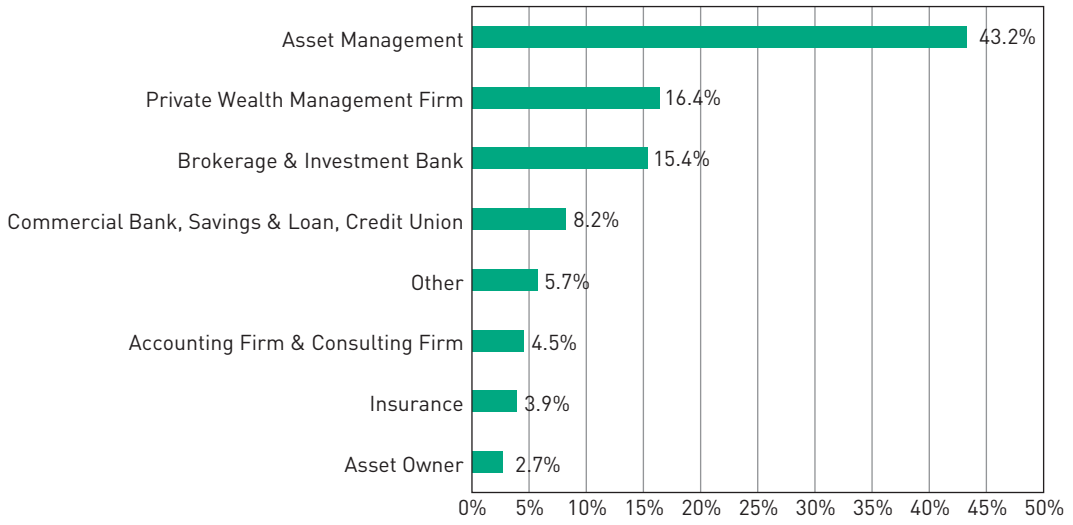


FIGURE 3A. BUY-SIDE RESPONDENT PROFILE BY FIRM SIZE (AUM)

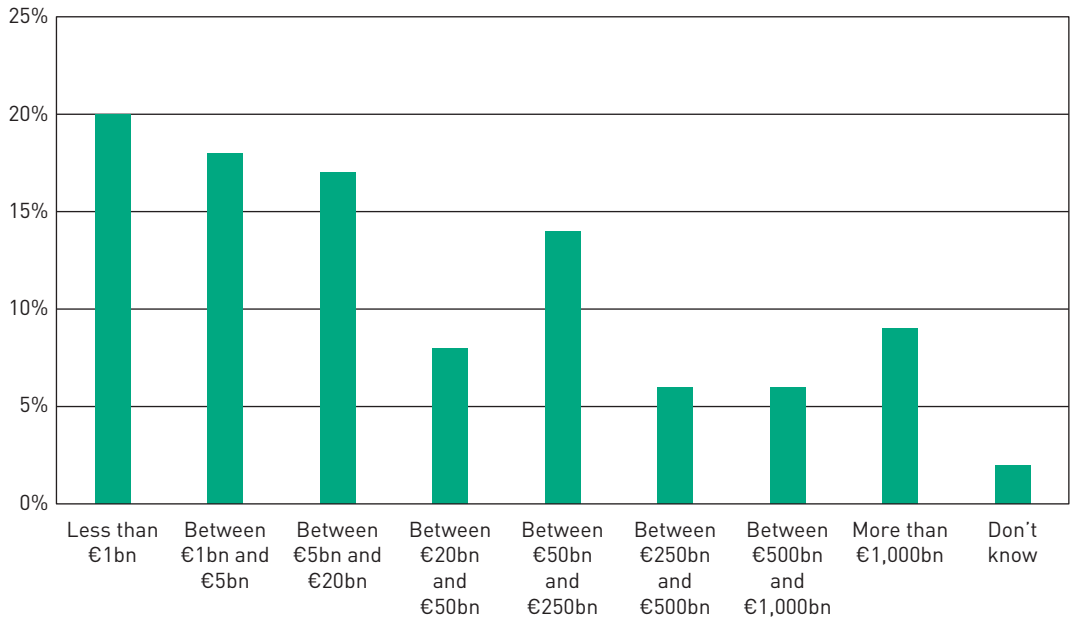
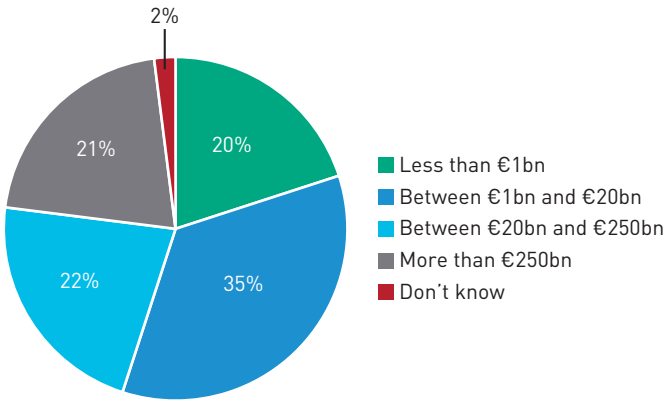


FIGURE 3B. RESPONDENT PROFILE BY FIRM SIZE (AUM, GROUPED)



3. Results

We tailored the survey questions according to which side of the industry (buy side or sell side) the respondent represented. For buy-side respondents, we sought to determine whether the firm or the client pays for investment research and asked: How does your firm pay for investment research?

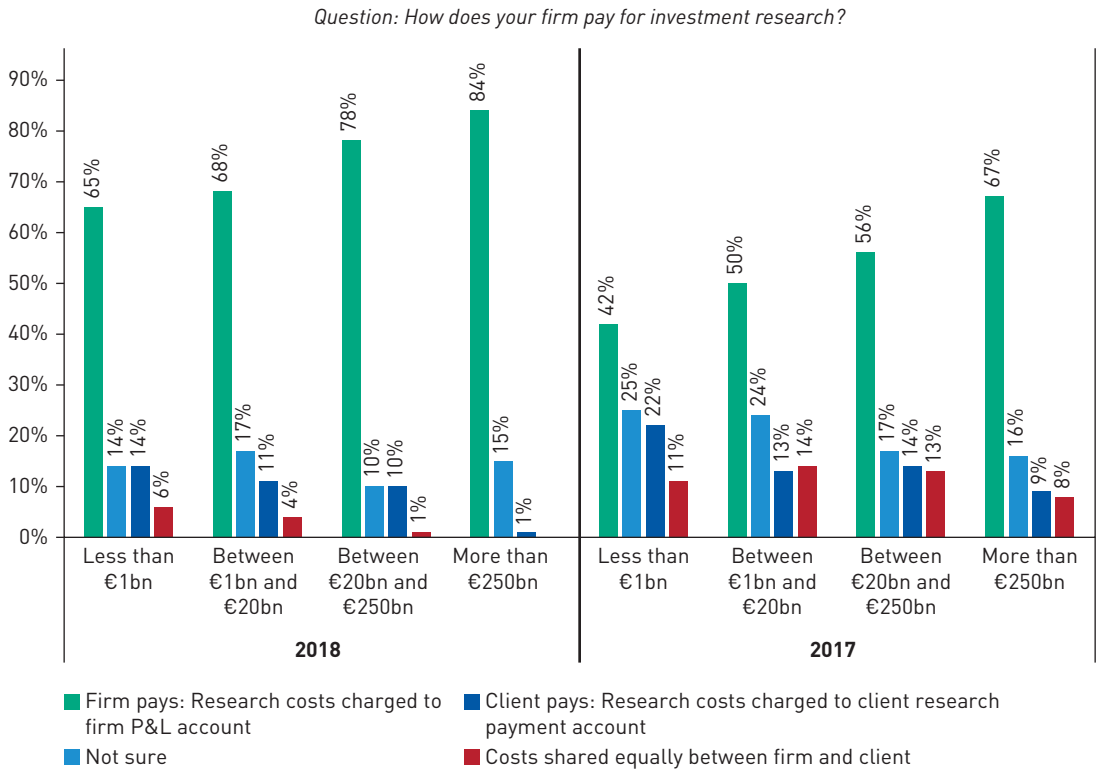
In the months leading up to the introduction of MiFID II in January 2018, industry professionals observed a general trend toward firms opting to pay for research (charged against the firm's profit and loss) as opposed to charging clients. This observation was corroborated in our 2017 survey data. One year on, the survey results affirm that trend, as **Figure 4** illustrates. The clear majority of respondents' firms pay for research, which holds true across all AUM size categories. We observed this same trend when analysing the results for this question according to the geographic distribution of respondents (not shown).

With clients (asset owners) of large investment firms expecting research costs to be paid by their managers, competitive pressures have forced most asset managers to absorb research costs. An additional factor behind the decision of firms to absorb these costs is the administrative convenience of doing so. Firms that opt to charge clients must establish research payment accounts, which carry additional regulatory requirements. Furthermore, booking the research cost against the firm's profit and loss may confer certain tax advantages.

Since the introduction of MiFID II, there has been little evidence of investment firms increasing their management fees to compensate for the absorption of research costs, which typically amount to a few basis points of AUM. This outcome is largely positive for end-investors, but it implies that asset managers face some additional margin pressure. This margin pressure most likely will be felt by smaller firms, which incur proportionately higher research costs per unit of AUM, suggesting a potential competitive tilt benefitting large firms.

A key business decision for asset managers is how much to budget for research. The budget is a function of a variety of factors, including the extent of reliance on external research providers, the type of investment strategy pursued (i.e., the research intensity of that strategy), and the nature of the firm's relationships with brokers (i.e., the firm's importance and therefore its bargaining power).

FIGURE 4. ATTRIBUTION OF RESEARCH COSTS UNDER MIFID II



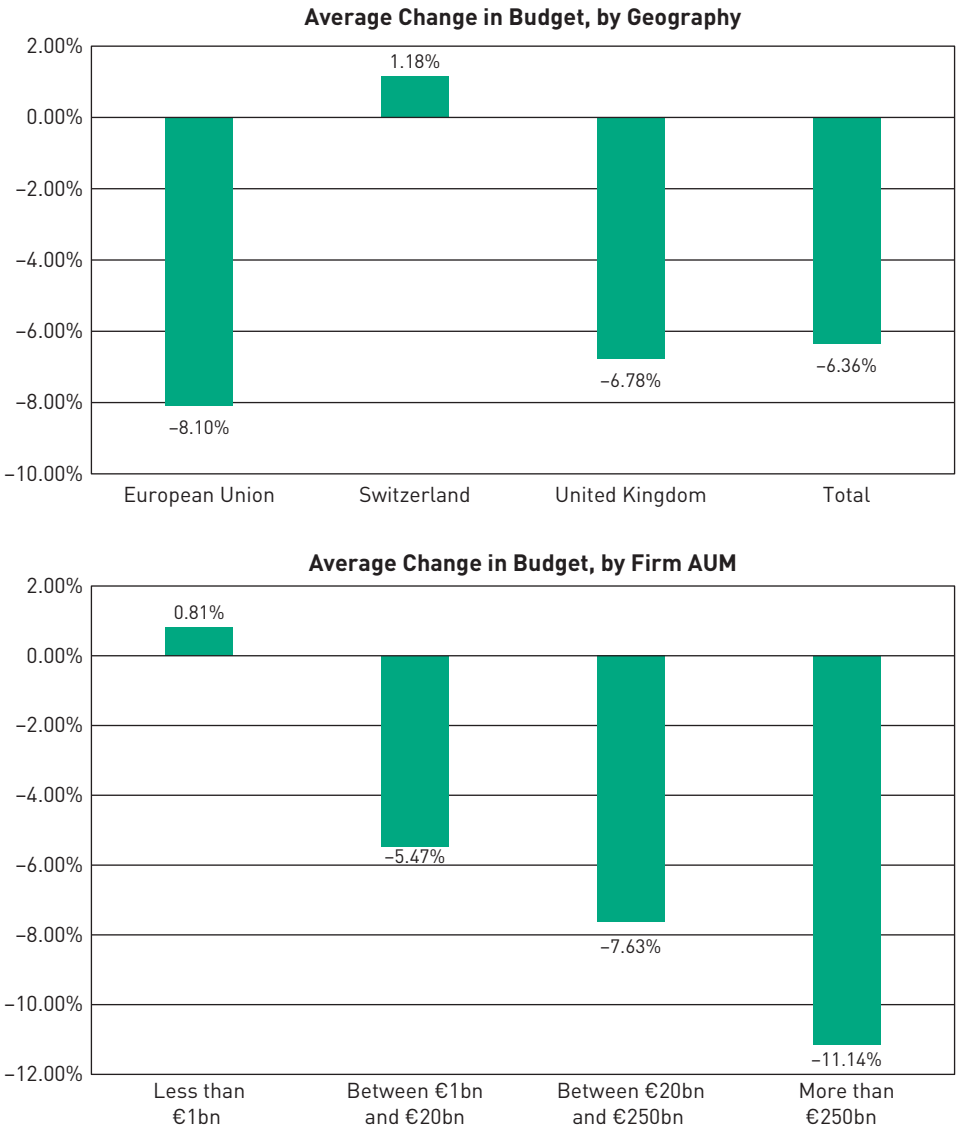
Note: Results are grouped by AUM of the respondent's firm, with 2017 data (right panel) shown for comparison.

To understand the effect of MiFID II on research budgeting, we asked: How has your firm's research budget changed since the introduction of MiFID II? **Figure 5** illustrates respondents' perceptions regarding changes in their firms' research budgets since the introduction of MiFID II. Across the full sample, the average decrease in research budget, according to respondents, is 6.3%. The reduction in budget, however, increases with firm size: for firms managing more than €250 billion of assets, the average budget reduction is 11%, whereas for firms managing less than €1 billion of assets, the budget change is negligible.

With firms absorbing research costs, these results suggest a greater focus on profitability and efficiency with regard to research procurement, and potentially a scaling back of the number of research inputs and external providers used to support a firm's investment

FIGURE 5. CHANGE IN RESEARCH BUDGETS UNDER MIFID II

Question: How has your firm's research budget changed since the introduction of MiFID II?



Note: This question was sent only to those respondents answering "Firm pays: research costs charged to firm P&L account" in the previous question (Figure 4). Respondents could select any point on a scale from -100% to +100%. Data were cleansed as follows: (1) Responses were truncated to remove the extreme responses (+/– 100%). (2) We removed erroneous responses from firms that were not asset management firms, duplicate responses, or conflicting responses from respondents at the same firm.

strategies. The disparity in the size of budget reductions between large firms and small firms may allude to the ease with which a firm can substitute externally procured research for in-house research.

Other possible factors behind the budget reductions include a narrowing of the scope of what constitutes "research" under the inducements rules as well as tax considerations, with research being invoiced separately from other brokerage services. More generally, against the backdrop of rising demand for passive investment products and strategies in relation to active strategies, firms may need marginally less research to support clients' investment objectives.

In the 2017 survey data, we observed an expectation among investment management professionals of a reduction in the amount of research that would be procured from the sell side (investment banks) under MiFID II, with research procurement shifting somewhat from the sell side to the buy side (in-house). Those expectations have been borne out in the first year of implementation of MiFID II.

Specifically, we asked: For each of the following research providers, how much research do you source compared to before MiFID II? **Figure 6** illustrates that 57% of respondents noted they source relatively less research from investment banks since the introduction of MiFID II. Approximately half noted that they use the same amount of in-house research, while 34% noted that they use more in-house research.

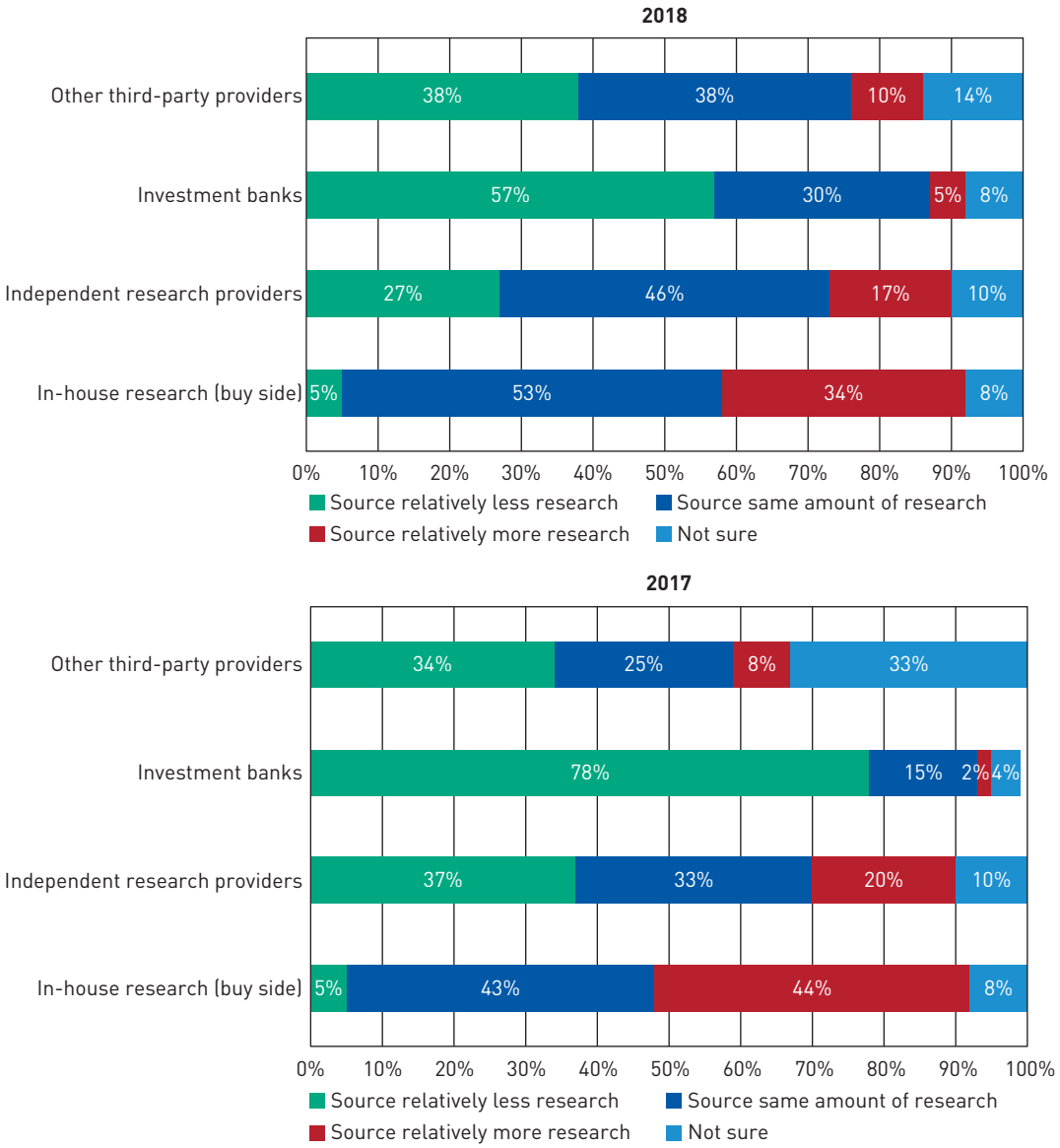
The results also suggest that independent research providers have not benefitted much from the introduction of MiFID II. More transparency and separate pricing of research are intended to create a more level playing field among research providers, yet it appears independent houses have not been able to grow their market share. As shown in Figure 6, only 17% of respondents source relatively more research from independent providers, which is little changed from expectations before MiFID II. As bulge-bracket investment banks have cut prices to maintain client business and squeeze competitors, independent providers appear to have realized little, if any, market share gains at this stage.

The advent of MiFID II led to a period of price discovery for research products and services. In the months leading up to the introduction of MiFID II, reported prices quoted by sell-side providers varied significantly, although reports suggested significant reductions in price quotes from initial estimates as providers competed to retain client business.

We asked both buy-side and sell-side professionals their views on research costs under MiFID. The results, presented in **Figure 7**, are broken down by asset class**.** The mixed

FIGURE 6. RESEARCH PROCUREMENT TRENDS

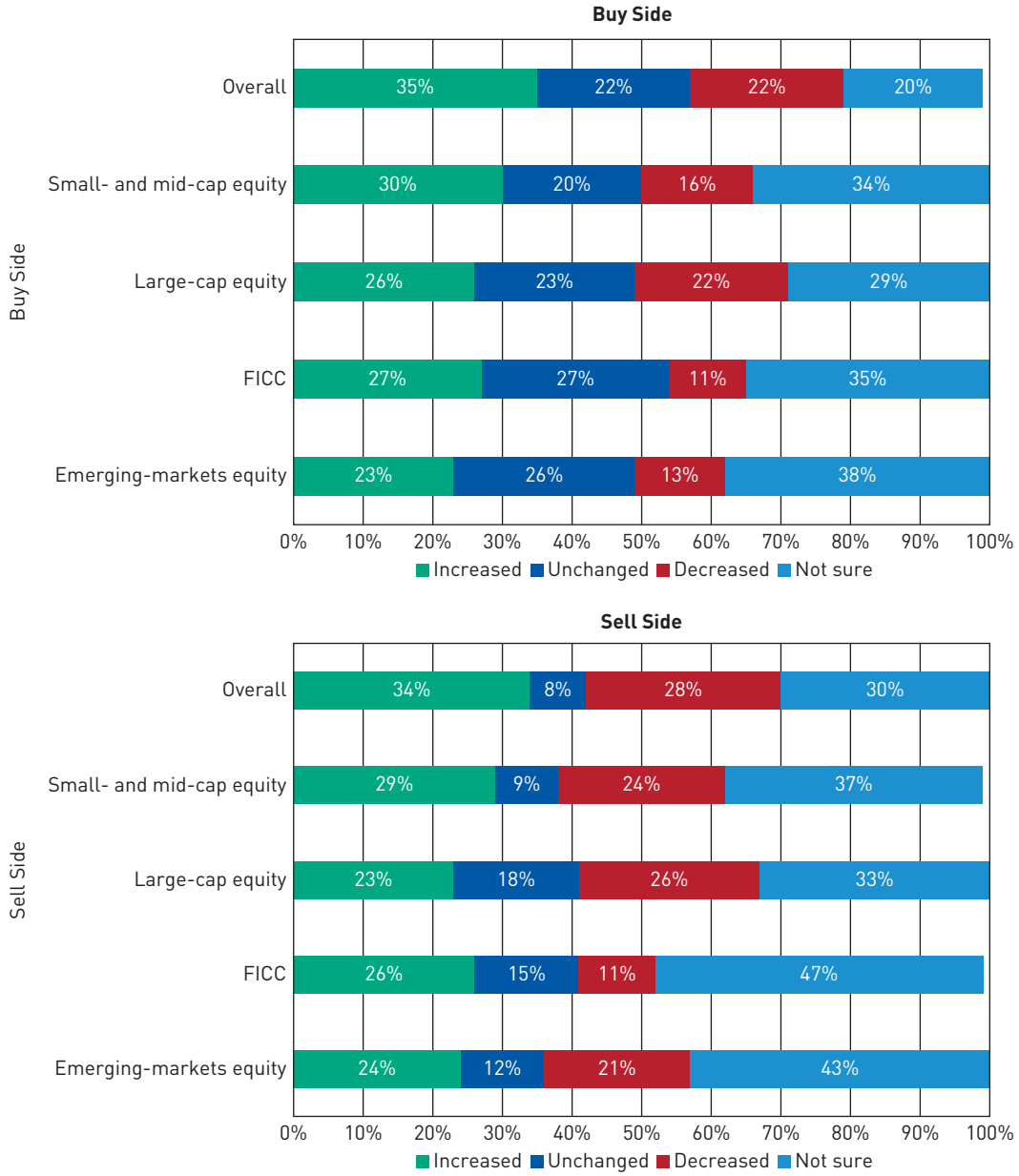
Question: For each of the following research providers, how much research do you source compared to before MiFID II?



Note: The 2017 data reflect respondents' expectations of how much research they would source from the different providers under MiFID II and are reproduced here for comparison.

FIGURE 7. RESPONDENT PERCEPTIONS OF RESEARCH COSTS

Question: Since the introduction of MiFID II, for the following asset classes, research costs have [increased, remained unchanged, decreased, not sure].



nature of the responses likely reflects the price discovery process, with research costs being discoverable for the first time. Moreover, the mixture of perceptions reflects the lack of clarity and comparability of research costs before the introduction of MiFID II.

In the case of fixed income, in which brokers are remunerated through the dealing spread as opposed to a trading commission, the relative majority of respondents on both the buy side and sell side were unsure about the change in costs, reflecting the difficulty of comparability with the pre-MiFID II regime. Overall, however, a relative majority of respondents felt that research costs have increased.

We next sought to determine the opinions of both buy-side and sell-side professionals on research quality and research coverage, respectively, under MiFID II, and asked: Since the introduction of MiFID II, for the following asset classes, *research quality* (**Figure 8**) and *research coverage* (**Figure 9**) has [increased, remained unchanged, decreased, not sure].

As the figures illustrate, very few respondents perceive an increase in research quality or coverage under MiFID II. Across all asset classes, less than 10% of respondents on both the buy side and sell side believe research quality or coverage has increased. This is concerning for investment managers and their clients, as well as for corporate issuers, and suggests the MiFID II reforms have not, as of this point, led to improvements in the provision of research.

As Figure 8 shows, buy-side professionals mostly believe that research quality is unchanged. Sell-side respondents are generally more pessimistic, with 44% believing that, overall, research quality has decreased.

Significantly, Figure 9 illustrates that approximately half of respondents on both the buy side and sell side believe coverage of small- and mid-cap equities has decreased, whereas coverage of large-cap equities appears to be mostly unchanged. This outcome suggests research providers are focusing their coverage on the more heavily traded, less-costly sectors. If this trend persists, the perceived lower coverage of small- and mid-cap stocks may exacerbate illiquidity in this sector and make it more difficult for corporate issuers to raise capital.

We also asked sell-side professionals their views about changes in the number of analysts employed following the introduction of MiFID II. As **Figure 10** shows, a clear majority of respondents believe that the number of sell-side analysts has decreased. This finding is consistent with the view of sell-side professionals in Figure 9: analyst numbers would appear to be falling as investment banks scale back their research coverage.

FIGURE 8. RESPONDENT PERCEPTIONS OF RESEARCH QUALITY

Question: Since the introduction of MiFID II, for the following asset classes, research quality has [increased, remained unchanged, decreased, not sure].

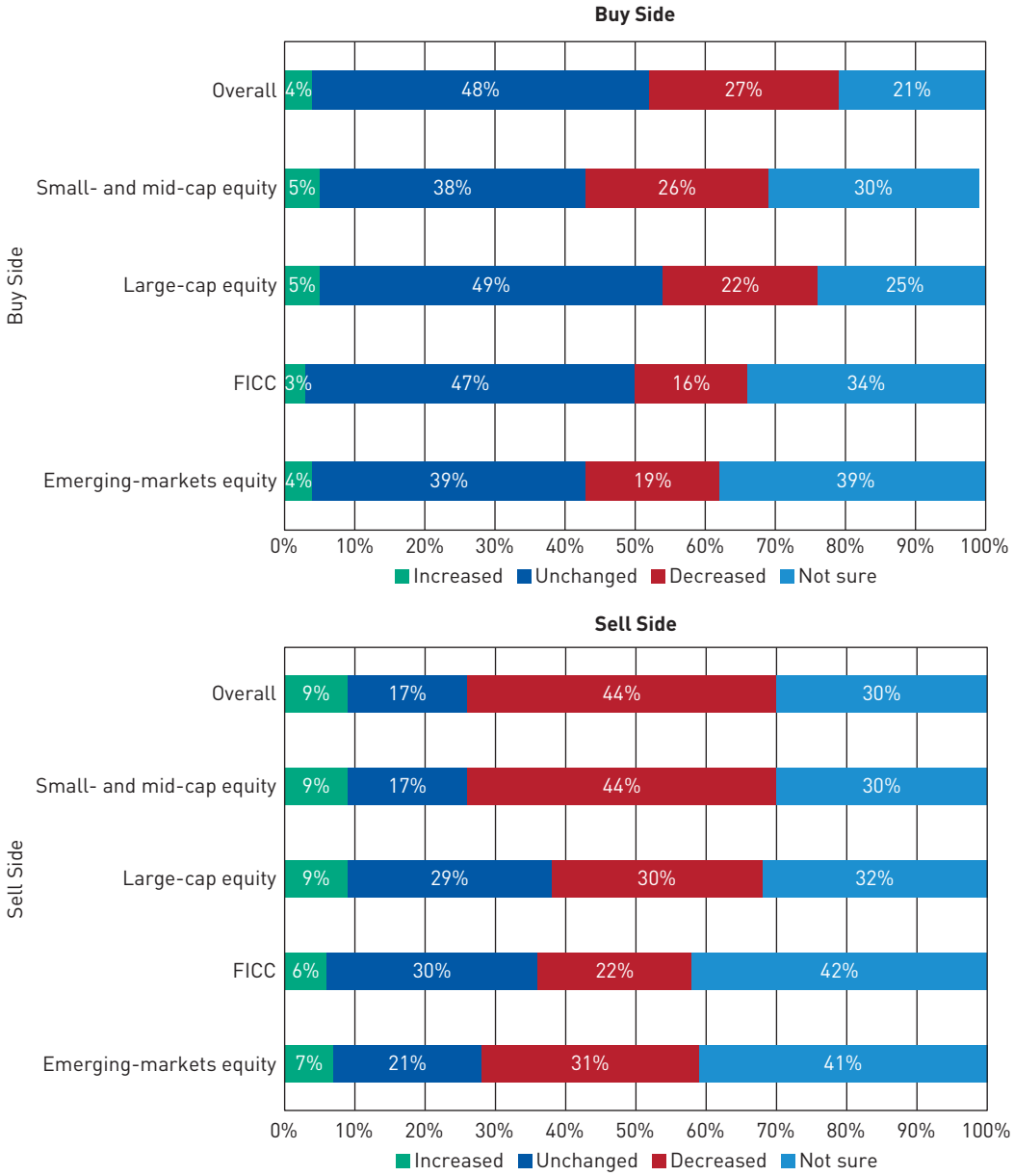


FIGURE 9. RESPONDENT PERCEPTIONS OF RESEARCH COVERAGE

Question: Since the introduction of MiFID II, for the following asset classes, research coverage has [increased, remained unchanged, decreased, not sure].

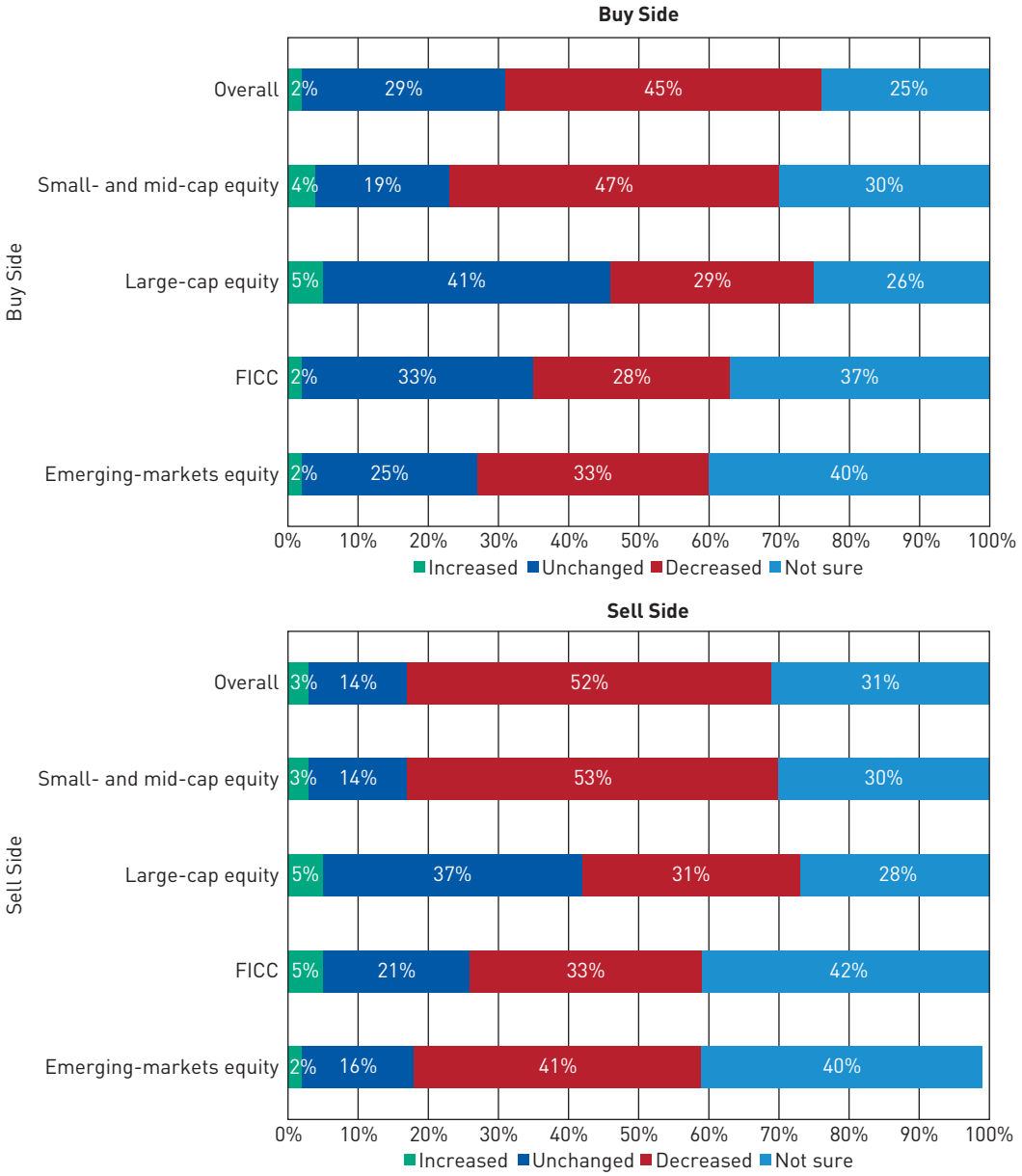
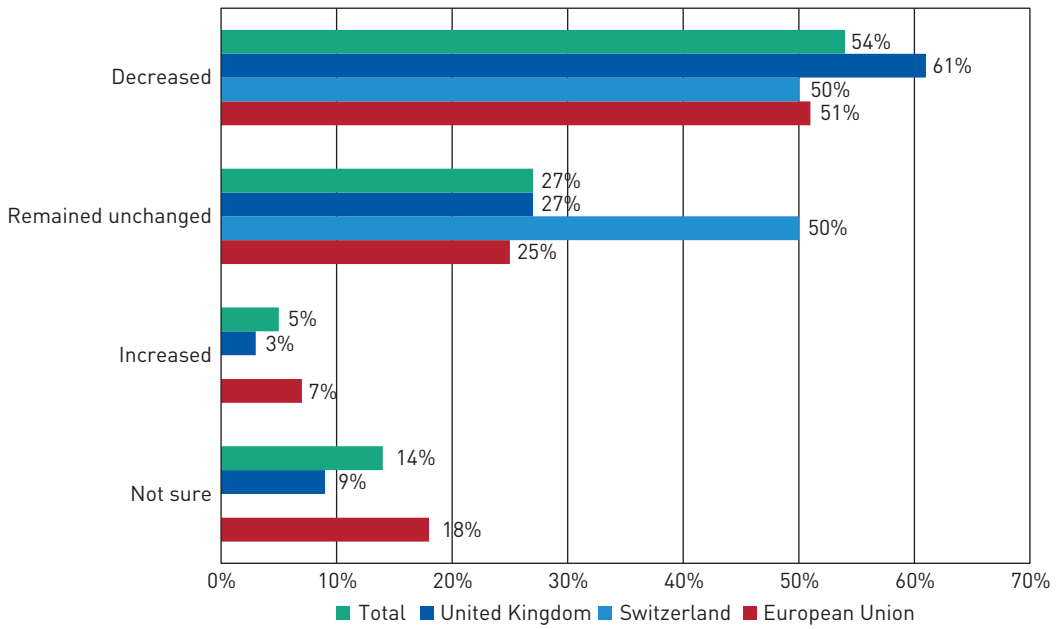


FIGURE 10. CHANGE IN THE NUMBER OF SELL-SIDE ANALYSTS

Question: Since the introduction of MiFID II, in your opinion, the overall number of sell-side analysts has [decreased, remained unchanged, increased, not sure].



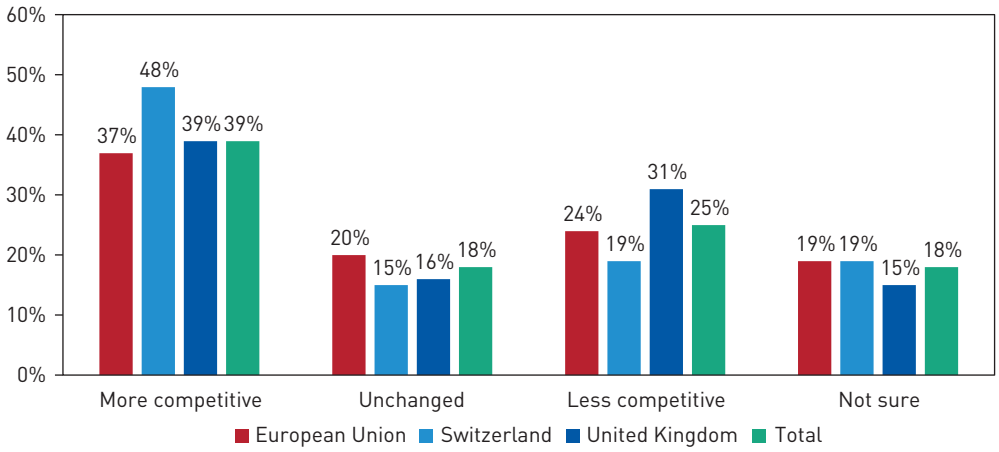
Taking stock of the changes introduced under MiFID II, we asked respondents their views of the overall competitiveness of the research marketplace: Since the introduction of MiFID II, the investment research marketplace overall has been [more competitive, unchanged, less competitive, not sure]. **Figure 11** presents the results by geographic distribution of the respondents. The responses are similar among buy-side and sell-side respondents (not shown).

Despite the somewhat pessimistic views revealed in Figures 8, 9, and 10, the relative majority of respondents perceive the research marketplace to be more competitive overall since the introduction of MiFID II, a generally positive outcome.

A possible explanation for this trend may be that the greater transparency over research costs and control over research expenditures imply a more competitive market, notwithstanding the aforementioned concerns over research quality and coverage.

FIGURE 11. COMPETITIVENESS OF RESEARCH MARKETPLACE

Question: Since the introduction of MiFID II, the investment research marketplace overall has been [more competitive, unchanged, less competitive, not sure].



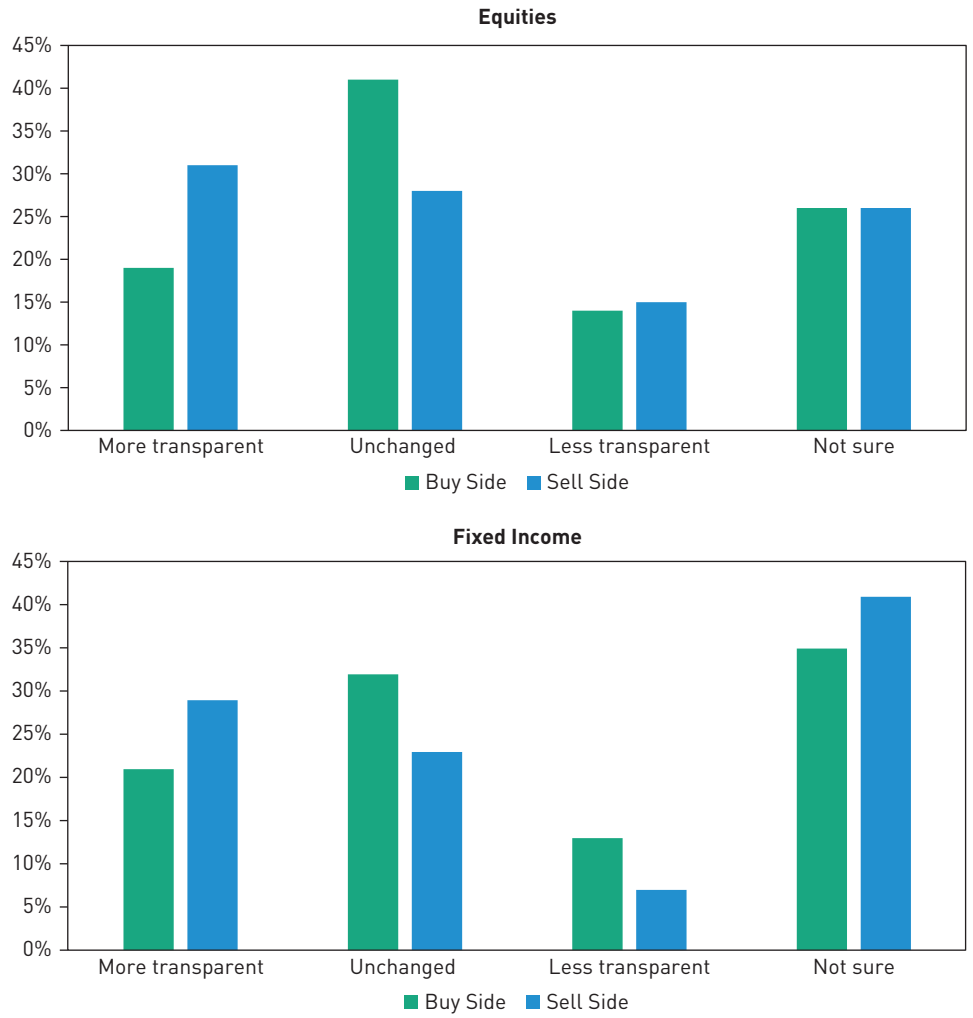
Aside from reforms to the rules for investment research, other significant aspects of MiFID II include the provisions regarding pre-trade and post-trade transparency in financial markets. Specifically, MiFID II introduced requirements for more price and transaction data in fixed-income markets to be made public and requirements to restrict the amount of equity trading taking place in dark pools.

We sought to gauge market perceptions of whether these trade-transparency provisions have made equity and fixed-income markets more transparent overall and asked: Taking these aims into consideration, what are your thoughts on market transparency after MiFID II? **Figure 12** illustrates the survey results. A relative majority of sell-side professionals believe equity markets are more transparent, a view expressed by 31% of respondents, whereas most buy-side professionals believe equity market transparency is unchanged, a view expressed by 41% of respondents.

In fixed-income markets, most buy-side and sell-side respondents are unsure about whether the markets are relatively more or less transparent. This likely reflects the limited extent of the fixed-income trade-transparency regime, with the vast majority of bonds in issuance classified as illiquid and therefore largely outside the scope of the public price–transparency framework.

FIGURE 12. VIEWS ON TRADING MARKET TRANSPARENCY

Question: MiFID II introduced requirements for more price and transaction data in fixed-income markets to be published, and to restrict the amount of equity trading taking place in dark pools. Taking these aims into consideration, what are your thoughts on market transparency after MiFID II?



Nonetheless, 29% of sell-side respondents believe fixed-income markets are more transparent overall under MiFID II, and only 7% of such respondents believe fixed-income markets are less transparent.

Finally, we asked survey respondents whether they believe MiFID II reforms are delivering better outcomes for end-investors. **Figure 13** shows that a clear majority of respondents answered negatively. This suggests that, at this stage, MiFID II is not meeting its principal objective in the eyes of the industry.

These results reveal general industry discontent with the disruption to business models and practices as well as the significant compliance costs associated with implementing MiFID II. The selection of comments provided by respondents, shown in **Figure 14**, illustrates investment professionals' concerns. The comments and the balance of sentiment provide additional context as to the areas in which the rules may not be working as intended.

With one year elapsed since the introduction of the rules, these results provide a snapshot of market sentiment; whether the burden of change ultimately delivers better outcomes for end-investors should be judged over the long run.

FIGURE 13. PERCEPTIONS OF THE IMPACT OF MIFID II ON END-INVESTORS

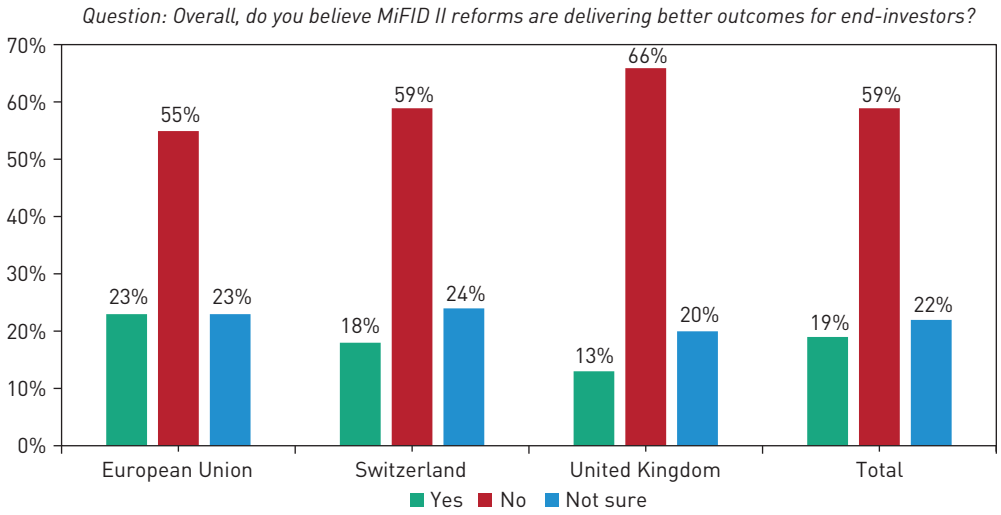


FIGURE 14. SELECTED COMMENTS FROM RESPONDENTS

Portfolio Manager: "Costs have resulted in firms reducing the number of third-party research providers and thus have less access to different sources from which to derive investment advice and ideas."

Portfolio Manager: "Eliminate the unbundling of research and execution on the fixed-income side. This has just decreased [the] availability of research, decreased the quality/breadth of research, and taken further liquidity out of an already illiquid market."

Sales Agent (sell side): "Even though in the short-term the costs with research have decreased for the buy side and end-investors, the budgets do not allow access to widespread research, thus creating much more room for information asymmetry. Additionally, the significant decrease in research costs are putting independent brokers at risk. . . . this should result in the closure of several independent brokers and an even larger dominance of global and financial institutions–backed brokers, which should also hurt the buy side down the road."

Investment Bank Respondent: "Fees for end-customers have not declined, yet there is less research available for small- [and] mid-cap and EM [emerging market] companies as buy-side budgets have been constrained. Consequently, only larger cap names are being well covered. Investors are concentrating their pools of research [on] the larger firms and bringing more of the research in-house. This means that only larger asset managers will be able to cover more names."

Research Analyst (buy side): "Cost/price transparency can only be better for clients. We have paid hard dollar research for years for this very reason and believe we also have achieved better execution by separating the two."

Portfolio Manager: "Clients might gain 20 bps from not paying for research, but 20 bps is easily lost in lower alpha generated-MiFID II might turn into a Pyrrhic victory for clients"

Portfolio Manager: "MiFID II favours large asset managers with scale. In [the] future there will be less competition in asset management. MiFID II also favours large research providers with scale. There will similarly be less competition in research provision. Gains from scale will result in a great deal of consolidation in asset management and in research provision. The resulting economies of scale will see lower fees charged to end-investors but at the expense of vibrant price discovery in capital markets. The result will be poorer allocation of capital in our economy."

Chief Investment Officer: "More accountability, better transparency, especially on fees and expenses."

Consultant: "Cost transparency allows clients to more easily assess net return on assets and compare quality of advice/management across firms."

4. Conclusion

The survey findings presented in this report portray several drawbacks with the MiFID II regime for investment research. The findings suggest a competitive tilt favouring large firms as research budgets and profit margins come under pressure from client demands, increased competition, and business model disruption.

These competitive pressures are best illustrated by the findings that asset managers are overwhelmingly absorbing research costs against their profit and loss, and they are scaling back research budgets accordingly. The decline in research budgets increases with the size of the firm, and larger asset managers are more likely and better able to move research production in-house as they scale back their reliance on external providers.

Perhaps the most directly observable drawbacks are the perceived reduction in research quality and coverage, particularly for small- and mid-cap equities, which if sustained, could hurt liquidity and capital formation in that sector. The findings suggest that research provision is retrenching and focusing on the large-cap segment, with fewer sell-side analysts employed.

On the positive side, however, investment professionals perceive the research marketplace to be more competitive overall, which perhaps reflects the extent of cost pressures and changes to research pricing, at least in the short run. Overcapacity in the supply of research is being removed, but it is an open question as to whether equilibrium has been reached that serves the best interests of end-investors.

CFA Institute

Author

Rhodri Preece, CFA, Head, Industry Research

Contributors

Gary Baker, CFA, Managing Director, Europe, Middle East and Africa, and Managing Director, Research

Kurt Schacht, JD, CFA, Managing Director, Advocacy

THE AMERICAS
(800) 247 8132 PHONE (USA and Canada)
+1 (434) 951 5499 PHONE
+1 (434) 951 5262 FAX

915 East High Street
Charlottesville, VA 22902-4868, USA

292 Madison Avenue
2nd Floor
New York, NY 10017-6323, USA

ASIA PACIFIC
+852 2868 2700 PHONE
+852 2868 9912 FAX

23/F, Man Yee Building
68 Des Voeux Road
Central, Hong Kong SAR

Si Wei (Beijing) Enterprise Management Consulting Co. Ltd.
Unit 5501, 55/F China World Tower B
No. 1 Jianguomenwai Avenue, Chaoyang District
Beijing, 100004, China

CFA Institute India Private Limited
702, 7th Floor, A Wing
One BKC Tower, Bandra Kurla Complex, Bandra (E) Mumbai 400 051,
Maharashtra, India

EUROPE, MIDDLE EAST, AND AFRICA
+44 (0) 20 7330 9500 PHONE
+44 (0) 20 7330 9501 FAX

67 Lombard Street
7th Floor
London EC3V 9LJ
United Kingdom

Rue du Champ de Mars, 23
1050 Brussels, Belgium

Al Maqam Tower, 7th Floor
ADGM Square, Al Maryah Island
Abu Dhabi, United Arab Emirates

ISBN: 978-1-942713-66-1

CFA Institute

www.cfainstitute.org
info@cfainstitute.org