Frost Research Systems

POST-MIFID II CLIENT COMMUNICATION/RISK MITIGATION OVERVIEW

This document is a guide for managers considering a return to a client-funded research/ESG model. It does not constitute legal or investment advice. It is intended as a practical implementation framework.

Client Communication/Evidence Template Overview

Overriding Objectives – Client-Funded Research Model

- The key objective is to protect asset owner returns by:
    - Reducing unintended market risks from investment product research/ESG budgets.
- Ensuring that the manager's investment product (and the asset owner's product return profile) remains globally competitive in the long-term, irrespective of market conditions.

Asset Manager Objectives – Crafting a Compelling Client Engagement Strategy

This will be bolstered by **Third-Party Evidence Frameworks**

Key Elements of Communication Strategy

- Internal asset manager communication:
    - Coordinated Firm-Wide messaging template
    - Senior Management, Client Service/Marketing/Legal teams, Investment Team, Operational Teams

External (Client) Communications

- Investor Benefit Matrix
- Giving asset manager client service teams a decisive data advantage in the client conversation.
- Quantifying the "research intensity" of various strategies.
- Battle-Tested client communication/risk mitigation strategies.

Investor Benefit Matrix

- Analysis and experience supporting the client-funded research/ESG model.

Research Value Assessment Framework

- Benchmarking
- Academic Validation
- Quantitative Models
- Cross-Subsidization Control

Risk/Reward Analysis for Manager Executive Committees

- Quantifying Risk and Return
- Timeframe Arbitrage – Long-Term benefits versus Short-Term risks

Why Doing Nothing is Not a Risk-Free Option

- Analysis of Industry Outcomes

About Frost Research Systems

Frost has played an active role in global research regulation since well before the onset of MiFID II.

Frost was heavily involved in the recent UK re-regulation including the Edinburgh Reforms Investment Research Review and the related HMT Call for Evidence. Frost worked actively with the last Conservative Economic Secretary to the Treasury as well as the UK Treasury, the FCA and the UK Pension Regulator in the lead up to PS24/9, the new UK research funding flexibility rules.

Frost has also been actively involved on research issues with other regulators including the SEC, ESMA, the AMF, BaFIN. Frost has done extensive academic work on the relationship between research spending and fund returns (cost vs. value) with the CFA UK, CFA Institute, Stanford University, the University of Edinburgh and commercial organizations including Bloomberg and EvercoreISI.

There is an extensive discussion of the historical antecedents of today's environment in the appendix at the end of the document.

Detailed Analysis

Overriding Objectives – Client-Funded Research Model

- The key objective is to protect asset owner returns by:
  - Reducing unintended market risks from investment product research/ESG budgets.
  - Facilitating access to critical investment research and data as AI models play a greater role in the manager/product investment process
- Ensuring that the manager's investment product (and the asset owner's product return profile) remains globally competitive in the long-term, irrespective of market conditions.

The two points above were the critical considerations motivating UK & EU Governments/Regulators to change the MiFID II research rules.

Asset Manager Objectives – Crafting a Compelling Client Engagement Strategy

This will be bolstered by:

Third-Party Evidence Framework: *(Example)*

- Work done by Frost in conjunction with:

  Academic Institutions: CFA UK, CFA Institute, Stanford University, the University of Edinburgh

  Regulators: FCA, the UK Pension Regulator, ESMA, the AMF, the SEC.

  Governments/Departments: UK Treasury, Department of Work and Pensions

  Industry Organizations: UK Investment Management Association, UK Capital Markets Industry Taskforce, US Council of Institutional Investors, HealthyMarkets Association

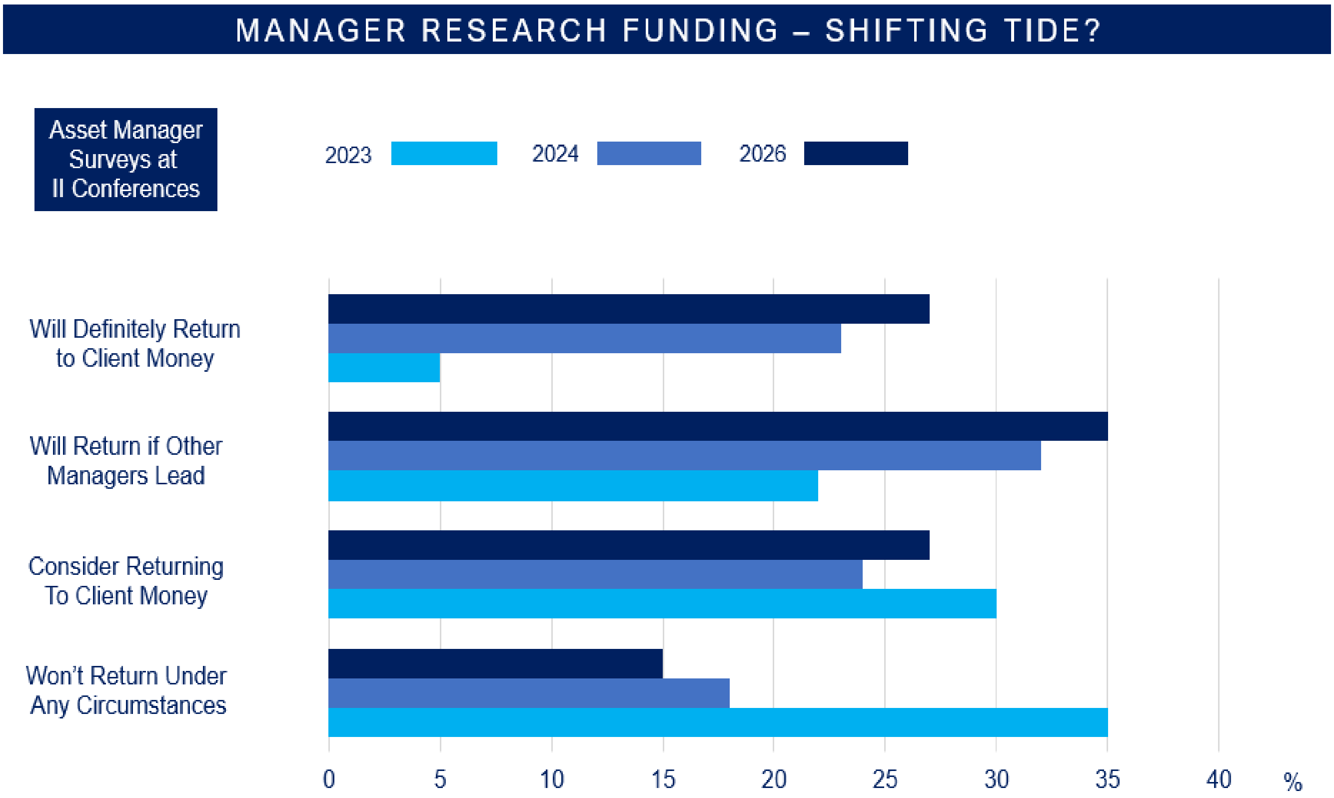
  Commercial Organizations: Institutional Investor, Bloomberg, Evercore ISI

Key Elements of Communication Strategy

- Internal asset manager communication:
  - Coordinated Firm-Wide messaging template
  - Senior Management, Client Service/Marketing/Legal teams, Investment Team, Operational Teams

Industry Research Funding Perspectives

The chart below shows shifting perspectives on research funding. These surveys of P&L managers were done at Institutional Investor Conferences.



The last survey, conducted in January 2026 indicated that slightly more than a quarter of the managers surveyed would definitely return to client money. If a further 35% would follow that lead, the market could turn very quickly.

The evolution of the fourth category, (managers who would not return to client money under any circumstances) illustrates the fluid nature manager research funding intentions. A widespread move back to client-funded research models would likely cause many managers in the fourth category to re-examine their positions.

Contrary to common perception, client-funded research never "disappeared" in the UK and EU. Frost is aware of more than 30 managers that continue to charge UK/EU clients for research, many of whom have done so throughout the MiFID II era. These managers collectively have thousands of clients.

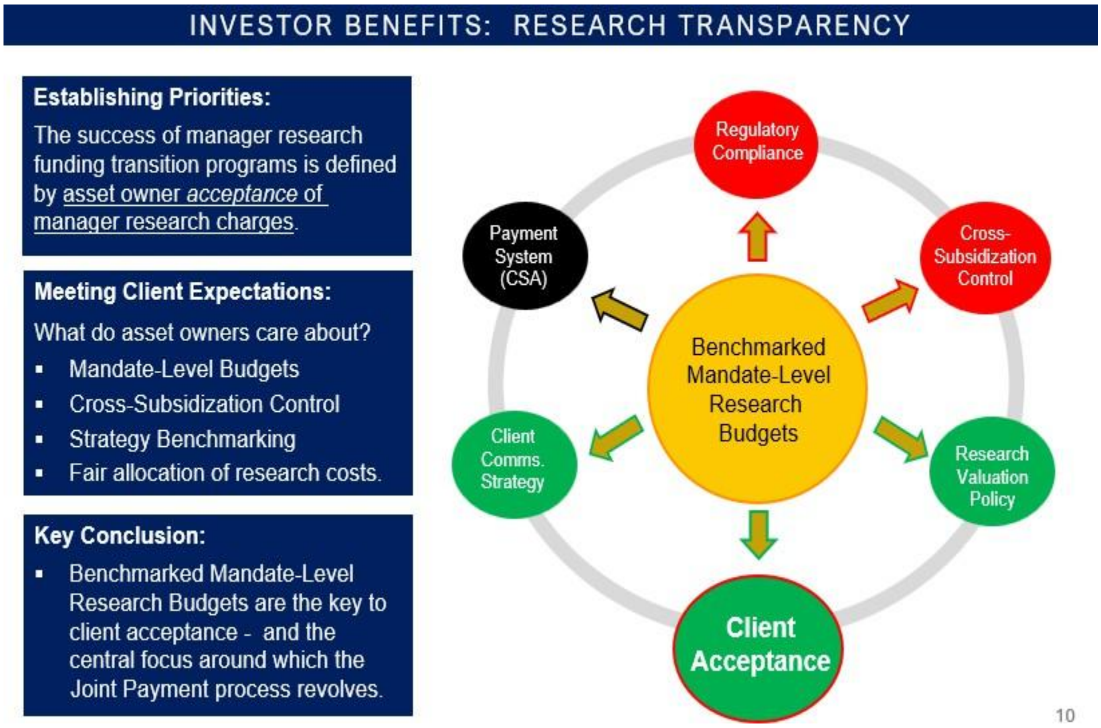
The bottom line for client service teams is that they need to be ready to adopt a client-funded model if senior management decides to pursue this course – and this could happen quickly.

External (Client) Communications

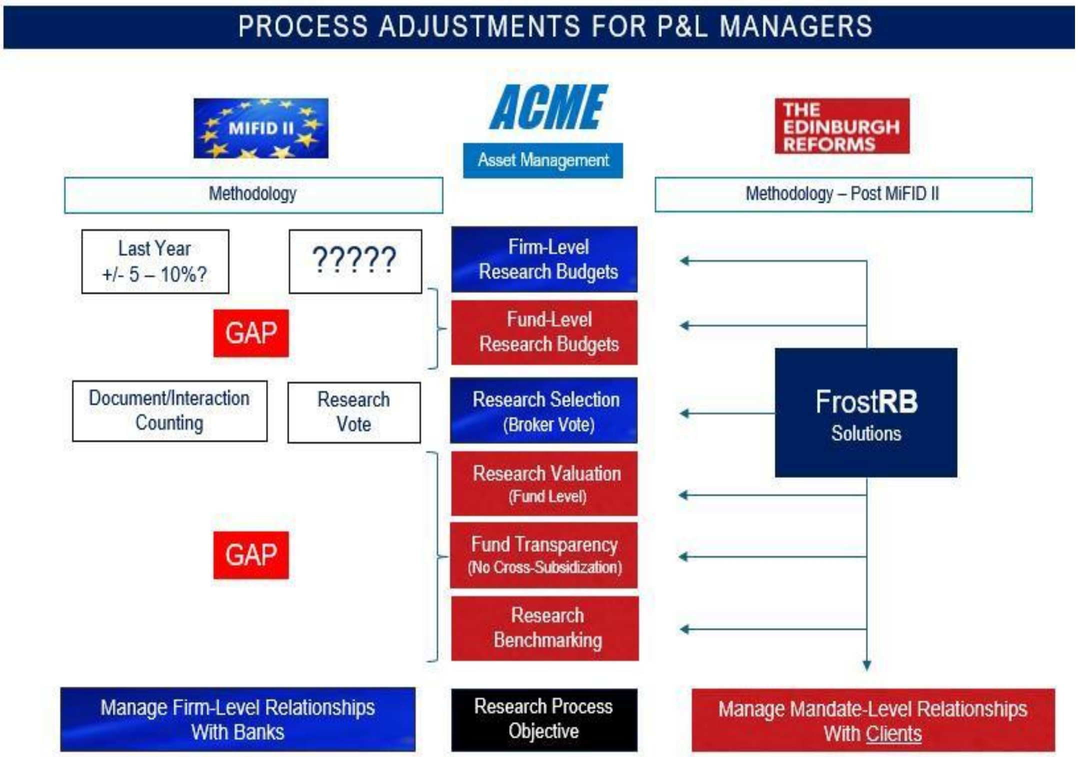
Investor Benefit Matrix

1. Mandate-Level Research/ESG Transparency

This is critical not only in terms of meeting regulation but bolstering confidence in the asset manager asset owner relationship. Benchmarked, mandate-level research budgets are central focus around which the entire post-MiFID II client-funded research model revolves.



Mechanisms exist to generate the specified levels of transparency and disclosure although this requires an alteration of the process used by most P&L managers.



A shift in emphasis is required to migrate from research valuation systems primarily designed to allow managers to administer their relationship with research providers (principally banks) to one that helps managers demonstrate research value to their clients. This is clearly important if clients are funding manager research bills.

2. Reduction of Unintended Market Risks to Product Research/ESG Budgets

One of the more insidious effects of the widespread funding of research budgets via manager P&Ls was the fact that this introduced substantial and unintended market risks to research budgets.

The P&L method requires managers to fund research (and ESG) from the pre-tax profit line which is heavily influenced by manager AUM (which drives revenue) and market direction which influences manager AUM.

For most of the MiFID II period, markets generally rose, masking this risk. However, 2022 was a watershed year in which both equities and bonds declined with a substantial impact on manager AUM (and revenues).

Given the operating leverage in the asset manager financial model, 20% AUM declines resulted in much greater declines in pre-tax profit.

UK/EU governments and regulators suddenly realized the perils of research funded by manager P&Ls: the lower markets went the less and less research managers could access as it was a function of their short-term profitability.

Was this in the interest of asset owners to “save” 2 basis points when the variance in performance between first and fourth quartile funds was frequently thousands of basis points?

An analysis Frost Consulting did for the UK Treasury concluded that in a 2008-magnitude equity event (56% peak-to-trough decline in the S&P 500), almost all UK/EU equity strategies would lose money at the pre-tax level. Then where would the research come from?

What was the implication for the global competitiveness of UK/EU managers when almost all US managers had their research (happily) funded by US asset owners?

3. Validation of the Client-Funded Research Model from Major US Asset Owners

At the onset of MiFID II, many US asset managers decided to adopt the widespread practice of paying for research via P&L for their UK/EU clients, but continued to charge US asset owners (who funded the vast majority of their research budgets).

This unequal treatment did not go unnoticed by US asset owners. But rather than insist on equal treatment, US asset owners twice wrote to the SEC endorsing the use of client money for research under certain conditions.

The letters were written by the US Council of Institutional Investors, the CFA Institute and the Healthy Markets Association.

US Asset owners were comfortable with manager use of client money for research as long as there was mandate-level research transparency and cross-subsidization control – the two main elements of new UK and EU research rules.

CII/CFA/Healthy Markets Letters to the SEC:

CII/CFA Letter to SEC - 2019: https://bit.ly/3Ltqmv8

CII/CFA Letter to SEC - 2023: https://bit.ly/4bmkqel

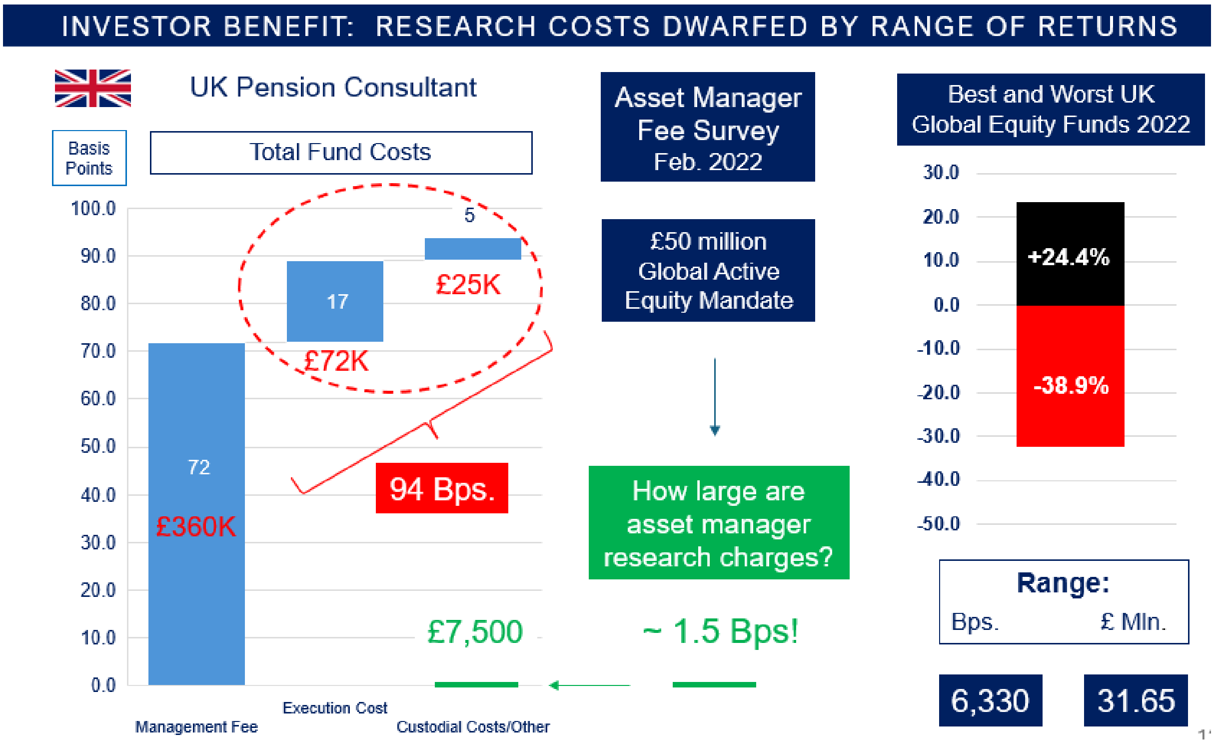
This is creating an emerging global standard for research transparency.

US asset owners were aware that they were indirectly subsidizing UK/EU asset owners that weren't paying for research, but preferred that outcome to forcing their US managers to fund research via P&L.

The critical question is Why

4. Asset Owner Research Costs versus Performance Outcomes

The chart below illustrates the answer. This is a fee survey done by a UK Investment Consultant looking at the average charges on a £50 million global active equity mandate.



The research charges (estimated by Frost) are miniscule, and a small fraction of the execution charges universally paid by asset owners on top of the management fee (and without complaint).

US asset owners recognize the relationship between tiny research charges and the huge variance in fund performance illustrated on the right side of the chart.

Most US asset owners would willingly pay a £7,500 research charge on a £50 million mandate to increase the probability that their external managers come towards the upper end of a £32 million performance range.

Another perspective relates to the sources of return in the portfolio. What could account for a ~6,000 basis point performance differential between the two managers at either end of the right-hand graph? Was it sub-optimal execution, or their choice of custodian banks?

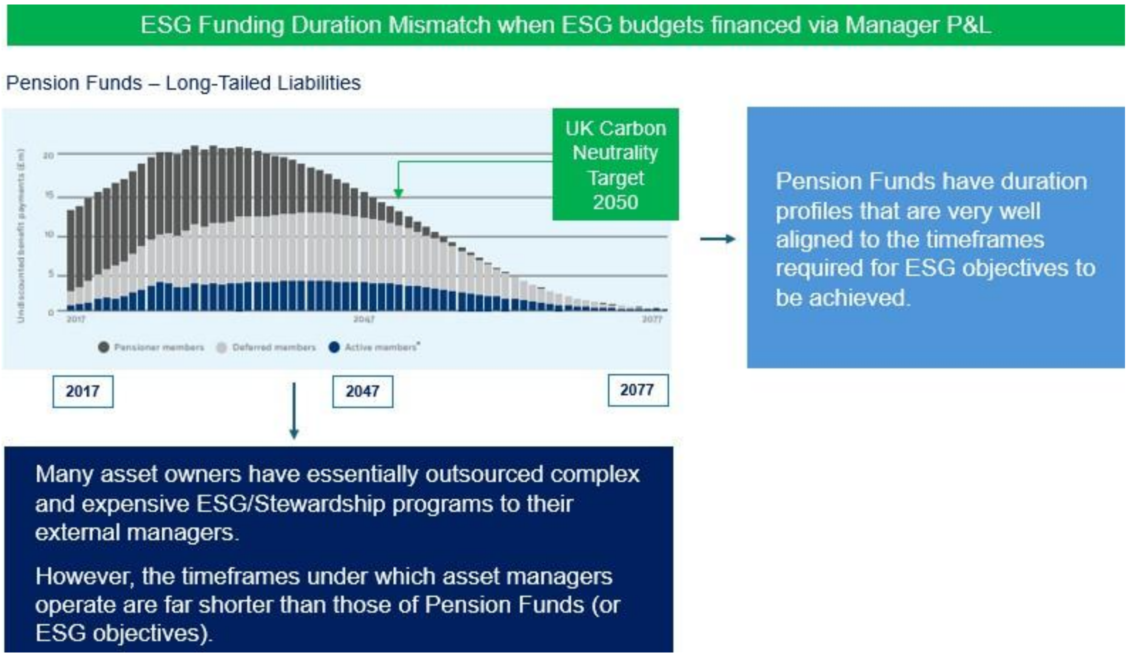
Obviously, it was driven by the investment choices made by the managers which are far more influenced by research than any other factor. Consequently, marginal "research savings" by asset owners may be a false economy.[1]

[1] Frost EvercoreISI Trans-Atlantic Research Spending and Performance: https://bit.ly/2MGlKTD

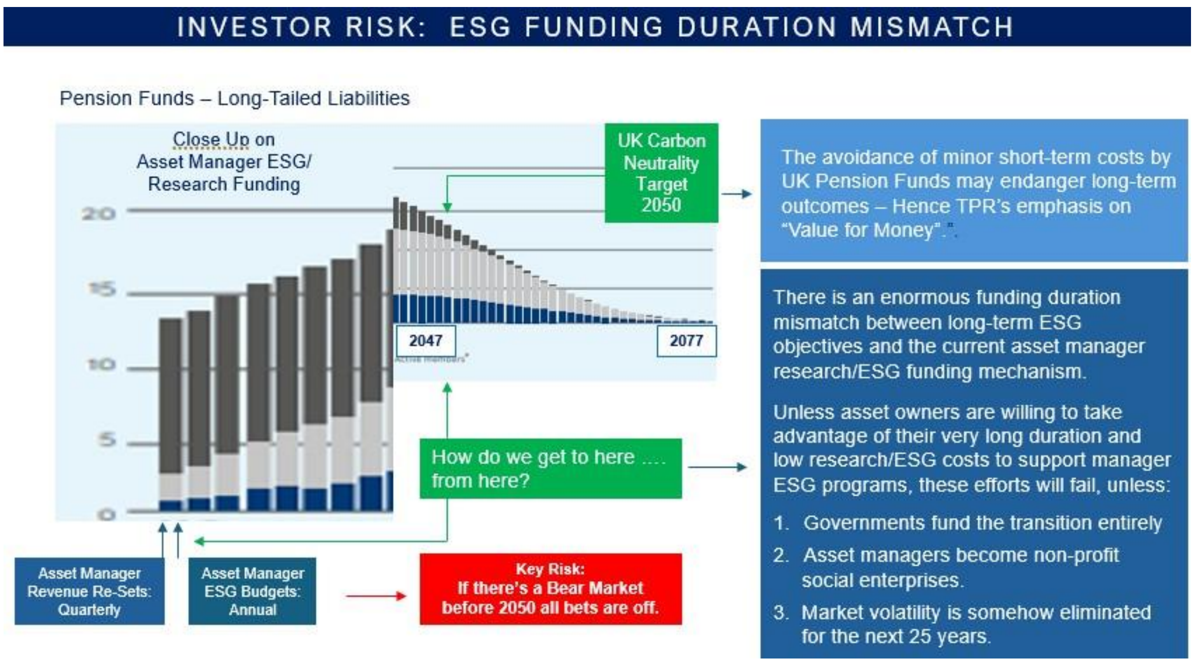
5. <u>Ensuring "Sustainable" ESG/Stewardship Strategies</u>

Many asset owners have outsourced their (increasingly expensive) ESG/ Stewardship strategies to external managers. But there is an inherent flaw in the ESG funding model which the industry is reluctant to acknowledge.

The chart below illustrates that the long tail of most Pension Fund liabilities aligns well with the timeframes required to achieve ESG objectives.

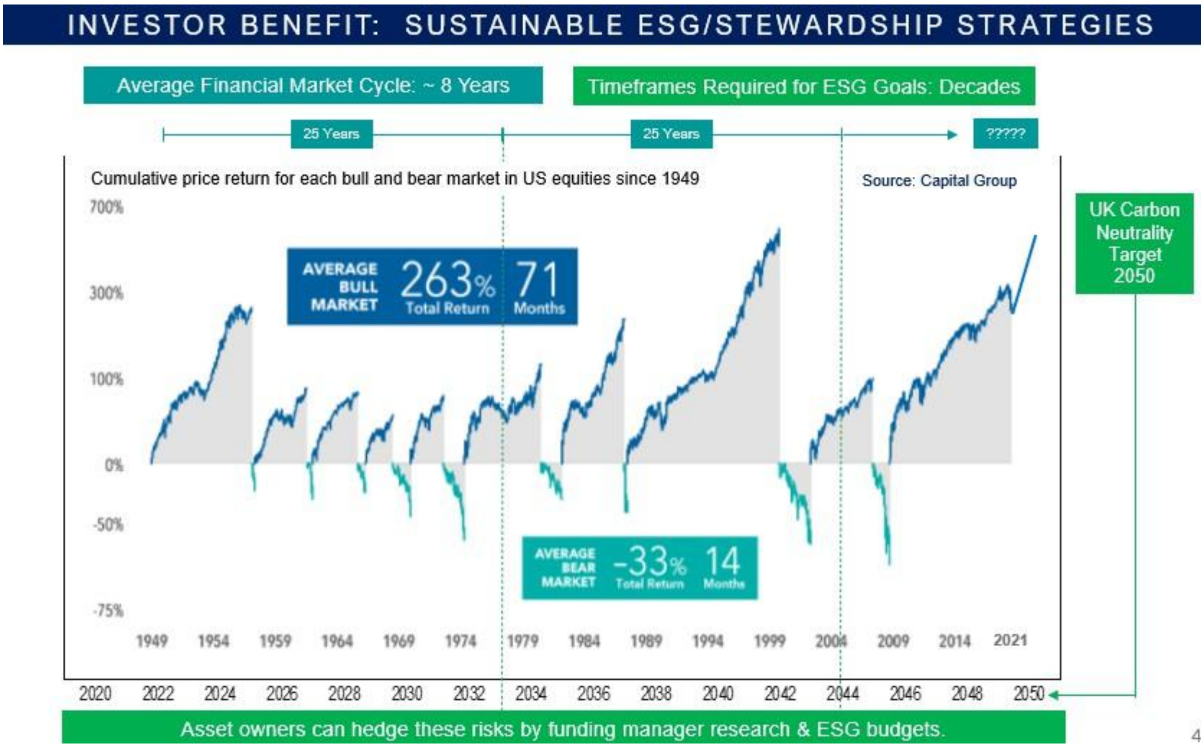


Asset manager ESG budgets are a function of their pre-tax profits, with revenues determined quarterly, 25 years in advance of ESG targets. There is huge mismatch between the (very) short-term funding of manager ESG budgets and the long-term objectives they are meant to achieve.



The obvious risk is a bear market which depresses asset manager revenue and profit thus potentially interrupting the funding of long-term ESG/Stewardship programs.

The issue is that ESG timeframes are far longer than the average financial market cycle.



The chart above shows the returns of US equities since 1949. The average length of a Bull Market was ~ 7 years and Bear Markets ~ 1.5 years. There is no 25-year period where markets advanced without interruption, which suggests that it's inevitable that there will be periods of market dislocation (and depressed asset manager profitability) before ESG objectives can be achieved.

To the degree that manager ESG (and research) budgets are a function of their pre-tax profitability, which in turn is a function of market levels and AUM, ESG objectives are subject to substantial market risks. No regulators or asset owners explicitly wanted this outcome. (An unintended consequence).

Asset owners can use their long duration and low research costs to help managers hedge those short-term market risks.

Asset owners want ESG objectives to be achieved and have no desire to see long-term ESG/Stewardship programs to be disrupted by market volatility.

Therein lies an opportunity for asset manager/asset owner collaboration on research funding to assure ESG objectives are "sustainably" funded.

6. Why ex-post client research charges do not automatically reduce investor returns.

There is a near-universal belief that all charges from asset managers reduce investor returns. As we'll demonstrate, this analysis is far less clear cut when it comes to managers funding research via P&L.

The fact that UK Pension Fund Trustees are obsessed with costs is not entirely surprising. This approach had been supported by governments and regulators historically. It is refreshing that DWP, TPR and the FCA are encouraging a more flexible and thoughtful approach to the issue.

The critical assumption that has driven asset owner and regulator obsession with investment costs (including research) is the notion, that, by definition, these costs reduce asset owner returns.

This assumption may be too simplistic, and the statistics frequently cited to support it are open to question, particularly when it comes to research funded by asset manager P&Ls.

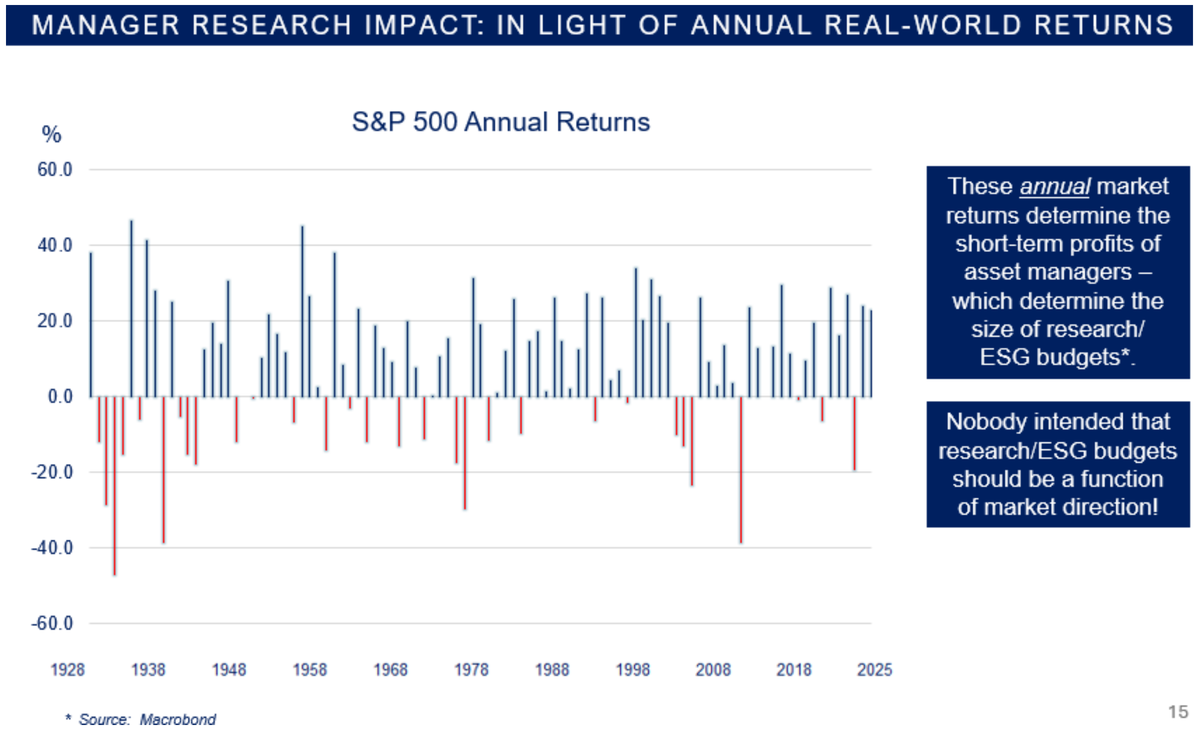
The chart below from the Financial Times outlines the familiar argument that led to some elements of the FCA (in the run-up to MiFID II) to strongly prefer that asset managers pay for research from their P&L. (Dotted lines added by Frost).

The obvious logic is, the higher that fund charges are, the more of the ultimate return they consume. The chart above assumes long-term returns of ~ 7%.

While the long-term return number is correct, that average is composed of individual annual returns that vary enormously. (The range is from ~ minus 40% to plus 40%).

This is where the transmission mechanism to manager P&L research budgets manifests itself. The short-term profitability of asset managers is not determined by smoothed long-term average returns. It is determined by the annual AUM levels of the manager which are highly correlated to much shorter-term annual equity returns.

As a proxy, the chart below captures annual S&P 500 returns since 1928.



The arithmetical average return over this period of 7.68%, does not capture the year-to-year volatility of the returns.

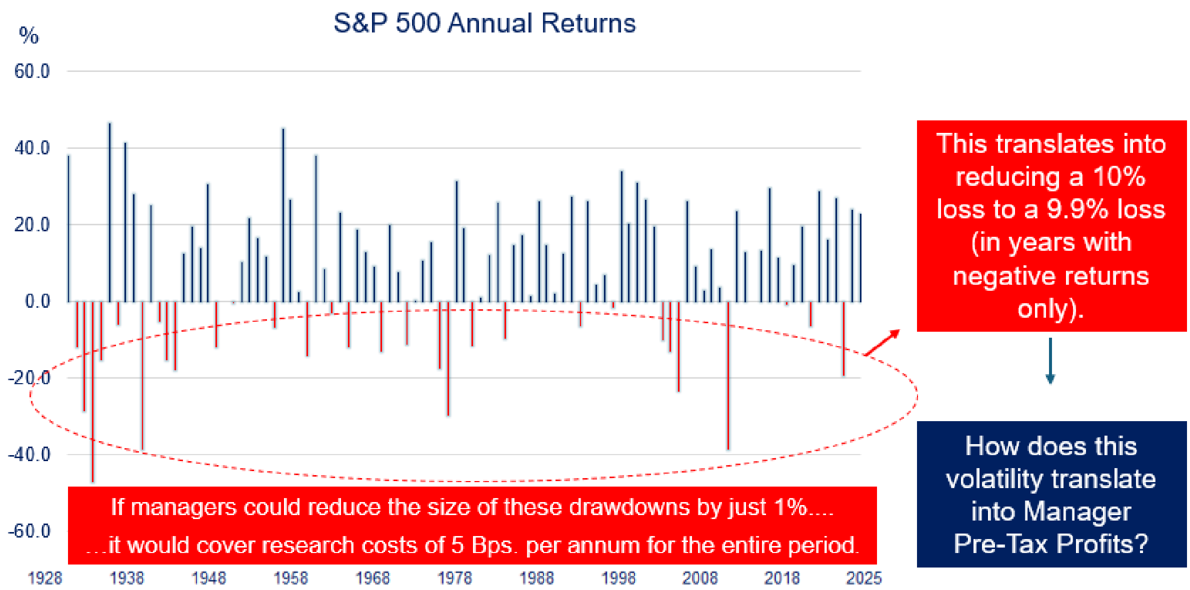
The most effective weapon that investors have in confronting a future which will likely continue to exhibit significant multi-asset class volatility, is maximum information. Constraining research costs and/or making research access a function of the short-term profitability of asset managers is not the way to do this.

Asset owners, investment consultants and fund rating agencies are paid to add value in either asset allocation and/or manager selection.

One would hope that a blinkered obsession with costs, in isolation, would not be their primary selection criterion. Small research charges do not guarantee manager/ product outperformance, but they increase the chances of managers outperforming passive products with no protection from market declines over longer timeframes.

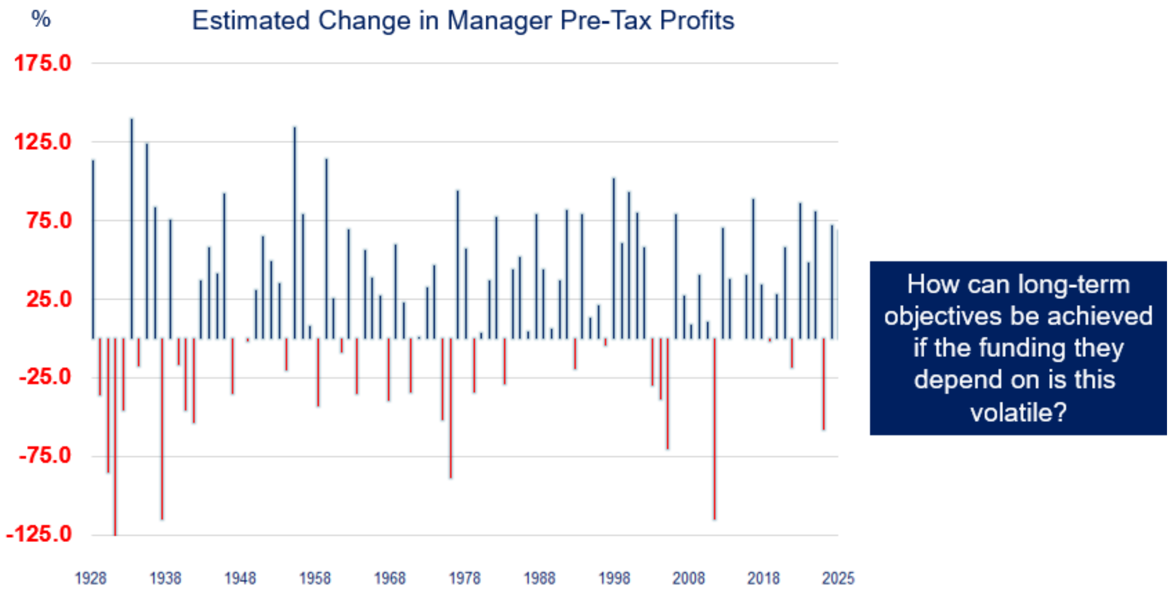
The analysis below suggests that if active managers could just reduce downdrafts by 1% (i.e. taking a 10% loss down to 9.9% loss) in down years only, those savings alone could finance a 5-basis point research budget over the entire period.

RESEARCH COSTS ... IN LIGHT OF ANNUAL REAL-WORLD RETURNS



Another critical factor is that the volatility of annual returns are amplified (particularly to the downside), given the significant operating leverage in the asset manager economic model.

IMPACT ON ASSET MANAGER PROFITABILITY



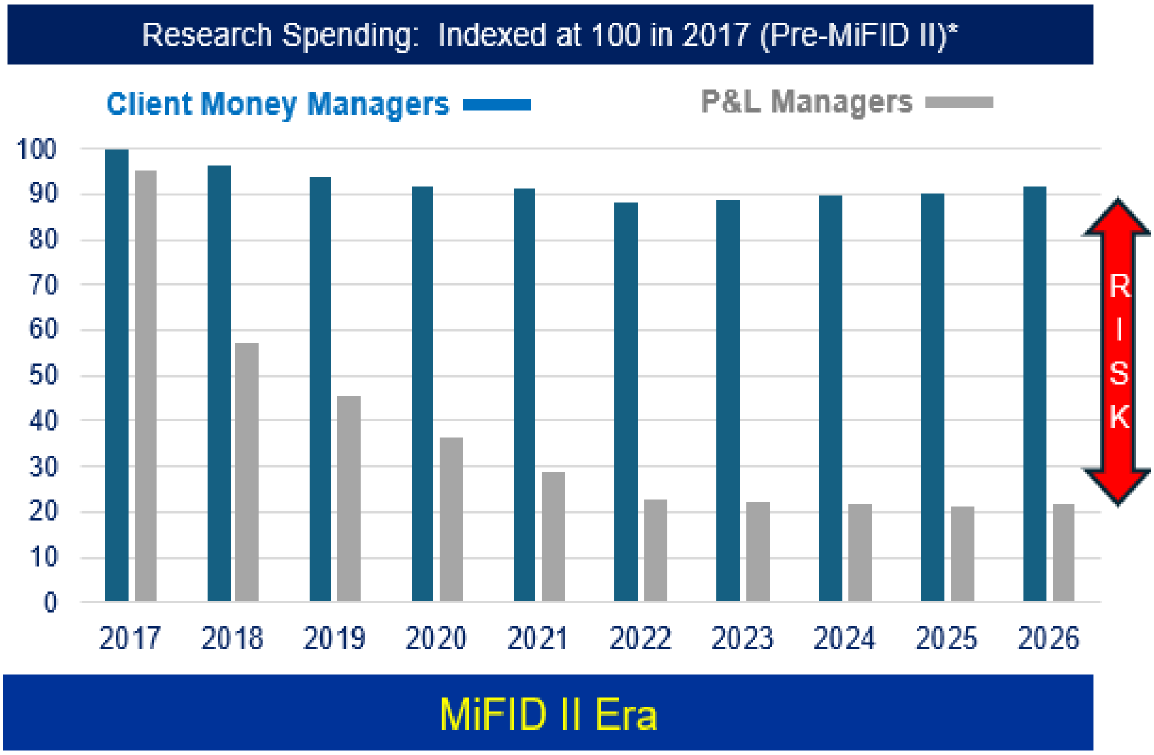
* Source: Frost Consulting Estimates based on S&P 500 annual returns

This raises the obvious question: How can long-term objectives of any type be achieved when the funding they rely upon is so volatile? (See ESG)

It seems unlikely that any regulator or asset owner would specifically design a system that resembles today's research via manager P&L regime.

7. Research/Performance Optionality as AI plays a greater role in manager investment processes

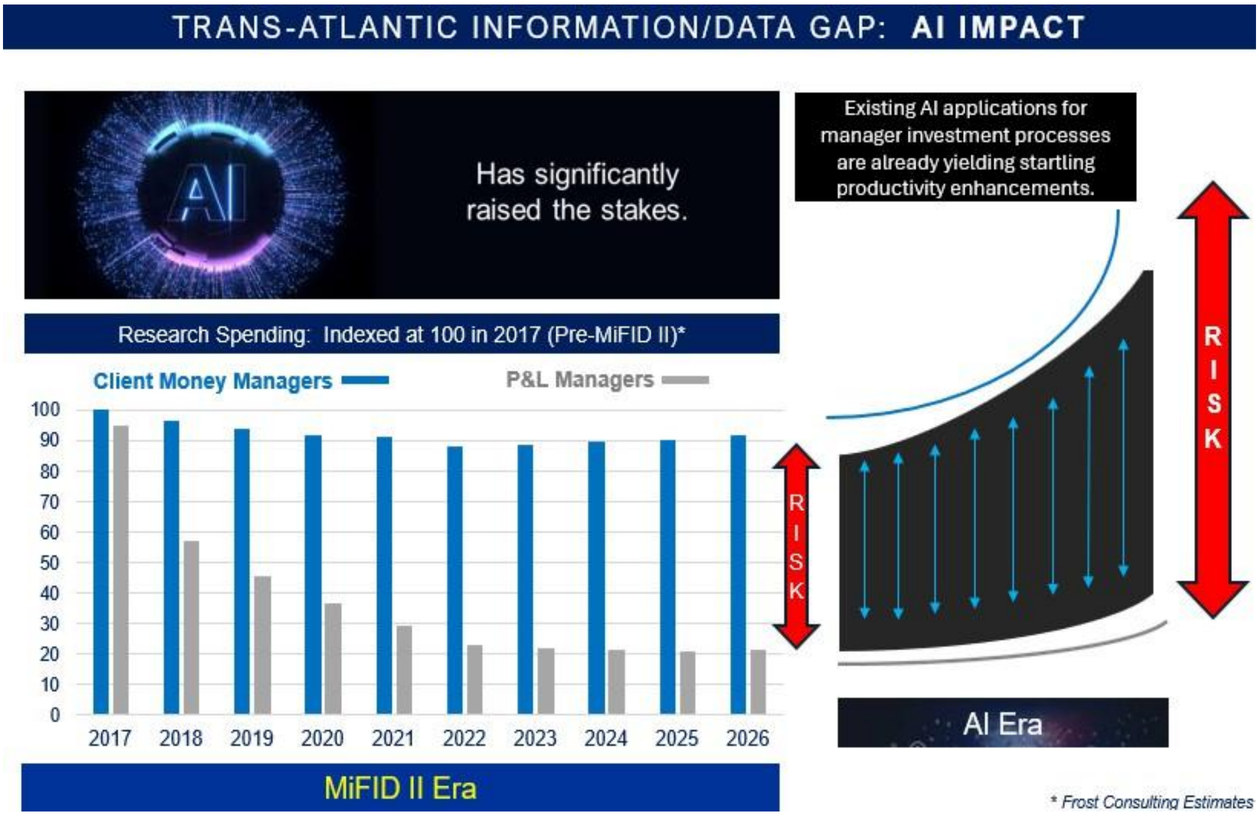
The Impact of AI and the Relationship with Research Spending



The chart above plots the relative research spending between managers funding research via P&L versus those using client money since before MiFID II (2017).

All industry observers agree that P&L managers have been at a research spending disadvantage. This spending gap represents information risk (as well as market risks). UK/EU regulators sought to ameliorate these risks via the recent regulatory change.

The rapid integration of AI models into the asset manager investment process threatens to widen this risk gap given the remarkable productivity improvements offered by AI as per the chart below:



The magnitude of this change is reminiscent of the transition from analogue to digital in many industries, but is happening much more quickly.

The issue is not so much the cost of AI models, but the amount of information and data that can be fed into and leveraged through them. Consequently, asset owners that remain fixated on de minimis research costs may be asking the wrong questions.

This technological transition may rapidly overshadow any debate about small research costs.

8. For UK Pension Funds – Realization of the Mansion House Agreements

The erosion of the UK capital market ecosystem has raised significant concerns amongst regulators, industry participants and policy makers across party-political lines. This has resulted in a number of broadly based initiatives to support capital origination and growth. We will touch on two here, and research plays a vital role in each.

The Mansion House Agreements

The Mansion House Agreements provide a clear illustration of the importance of investment research to both asset owner returns and to the UK capital market as a whole. The agreements commit 17 large UK Pension Funds with collective AUM of £250 billion to put 10% of their AUM in unlisted equities (including listed equities on

AIM and Aquis). The result is that they will have a large allocation to very illiquid securities.

The illiquidity of the holdings suggest that the pension funds would have to develop a high level of fundamental conviction in these investments, as well as an extended time horizon.

The decline in research availability for UK small cap. stocks which was a major focus of Rachel Kent's Investment Research Review, may challenge the ability of UK Pension Funds to access the information needed on these smaller companies.

The spate of defensive mergers in the UK Small Cap Brokerage industry suggests that the firms that would normally produce research on smaller companies are suffering significantly, primarily from the impact of MiFID II resulting in vastly reduced asset manager P&L research budgets. Frost estimates that revenues received by UK small cap. research producers has declined by more than 80% since pre-MiFID II levels.

Unless Pension Funds agree to fund manager, and by extension, research producer research budgets, creating research on these smaller UK companies will not be economically viable.

Because of the illiquidity risk and shortage of research, small cap research budgets are normally higher than budgets for larger cap strategies in general.

Expecting managers running UK small cap strategies to fund research budgets via their P&Ls will be counter-productive (as well as penny-wise and pound-foolish). The long holding periods for these assets increases the likelihood of significant market volatility which could substantially impair these managers and asset owner's ability to access the investment research they need on these smaller companies.

In conversations Frost has had with the CEO of the UK Pension Regulator, she is sympathetic to the idea that the Mansion House objectives are far more likely to succeed if UK Pension Funds finance manager small cap. research budgets, but with one main caveat:

Nausicaa Delfas
Chief Executive Officer
The Pensions Regulator

It is important to understand the value chain between pension funds and their suppliers and ensure that pension funds only pay for the services they receive.

Cross-subsidization control will be a key part of client research transparency expectations.

FCA/TPR "Value for Money" Pension Framework

The TPR/FCA CP24/16 Consultation Process is a critical element in the TPR's ambition to shift the priorities of UK Pension Funds from an obsession with costs (at the expense of all other considerations) to a more balanced "Value for Money" (VfM) approach.

VfM implies that the lowest cost product is not always in the clients' best interest and this approach allows Pension Funds to consider returns as well as costs. (The prioritization by UK Pension Funds of costs has been blamed in part for the reduced exposure to active equity products and to the UK equity market in particular.)

A related initiative is the Employers Pension Pact. This agreement between 20 large UK employers, including several vertically integrated financial companies and asset managers, commits the members to choosing pension products for their corporate schemes based on the highest net return rather than the lowest cost.

Overarching Conclusion

The FCA/TPR VfM consultation papers detail extremely desirable outcomes for pension recipients. Underpinning virtually all of those objectives is robust investment research.

Its vital role is widely acknowledged in academic research as well as the UK Investment Research Review.

In our paper with Stanford, we made the novel argument that asset managers and asset owners should collaborate on research budgets. Why?

Because both parties want the asset managers product to achieve its targeted returns. Clearly the asset manager wants to product to do well, and the asset owner has selected it as a component of their portfolio construction.

A key question for the UK Pension Regulator is whether UK Pension funds are maximizing the Value for Money they are receiving from external managers by denying them a couple of basis points of research cost when the performance gap between first and fourth quartile funds is frequently thousands of basis points across dozens of active equity categories?

Why would a UK Pension Fund, or any asset owner, seek to handicap or in any way constrain an investment strategy that they've consciously sought exposure to, by objecting to tiny research fees?

The Investor Benefit Matrix section of the paper echoes that question. Many of the elements of this analysis will feed through into the next section on External Communication Strategy.

Giving Asset Manager Client Service Teams a Decisive Data Advantage in the Client Conversation

An integral part of providing mandate-level research transparency is understanding what the research needs of the strategy are. It's in the interests of asset owners to ensure that strategies are appropriately resourced.

It is universally recognized that not all strategies need identical research budgets. The Frost Framework below, uses Expected Return and Volatility to assess the "research intensity" of different strategies.

Typically, higher targeted return strategies are typically taking more risk of some type (liquidity, duration etc.). and frequently need higher research budgets. A global Emerging Markets equity fund that has to follow 20,000 companies in 50 countries will need a higher research budget than a fund that invests in US Treasuries, where there is one issuer and one on-the-run bond.

Asset owners inherently understand this concept because this is the way they view asset manager products in their portfolio. Each has a job to do, and the asset owner has return and volatility expectations of each product.

This framework is a critical part of helping client service teams explain how the product research budget was derived.

This is further refined with highly customizable quantitative models that can account for the size of the investible universe, AUM scale and research scarcity amongst other variables. The model itself will generate a suggested research budget for the specific strategy.

RETURN-BASED METHODOLOGY: TOP-LINE STRATEGY BUDGETS

FrostRB

Research Intensity Methodology

Reflecting Manager-Specific: Expected Return/Volatility Portfolio Construction

Historical Inputs

Manager/Product-specific customization

Multi-Asset Class

2014 - 2024

Asset	Return	Volatility	Adjustments Bps. Universe Size	Adjustments Bps. Scarcity Premium	Adjustments Bps. AUM Scale	Frost Research Budget Target Bps.	FrostDB Resarch Strategy Benchmarks (% Relative)
Cash (3m T-Bills)	??	??				XXX	69
Bonds (Barclays US Agg Bd Index)	??	??				XXX	132
Global Bonds (JPM Global Gov. Bond Index)	??	??				XXX	101
Diversified Portfolio (equal weight)	??	??				XXX	46
Large Cap Value (Russell 1000 Value)	??	??				XXX	137
Commodities (Bloomberg Commodity Index)	??	??				XXX	54
International Stocks (MSCI EAFE)	??	??				XXX	96
Large Cap Growth (Russell 1000 Growth)	??	??				XXX	178
Small Mid Cap Growth (Russell 2500)	??	??				XXX	89

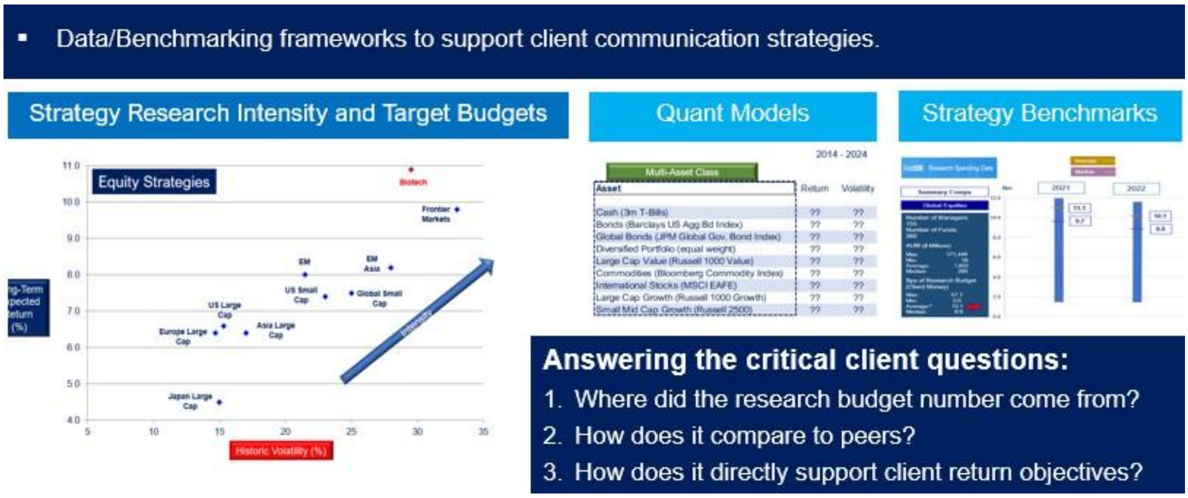
Proprietary Forecasts

Generates Model Predicted Values for Strategy Research Budgets

Frost**RB** answers the critical client questions:

1. Where did the research budget Clientnumber come from?
2. How does it compare to peers?
3. How does it directly support client return objectives?

This culminates in the “data advantage” in the client conversation:



This, in turn, forms a critical part of the

- Battle-Tested Client Communication/Risk Mitigation Strategy.

KEY ASSET MANAGER RESEARCH COMMUNICATION SOLUTIONS

- **External:** Client Communication Strategy
  - a) Low impact communication template – Routine “Business as Usual” Communication
  - b) Demonstrating that research budgets are aligned with the agreed investment strategy.
  - c) Demonstrating that fund research charges are reasonable relative to peers (Benchmarking)
  - d) Demonstrable cross-subsidization solutions.

Example Client Communication

- As of Jan. 1, 2026, Acme Asset Management will add a 2-basis point charge for research to the XYZ fund.
- This is to ensure our investment teams’ continued access to external research central to our agreed investment strategy, in light of legal and regulatory changes in the US/UK/EU.
- We will fully comply with research transparency guardrails contained in recent UK FCA Policy Statements. (PS24/9 & PS25/4)

Experience suggests that the vast majority of these types of routine client communications rarely result in asset owner objections – if the emails are even opened.

Frost has had substantial experience helping managers craft client communication strategies. Our experience is that this is best handled as a “low impact communication template”, in a “Business as Usual.

The ability of Client Service teams to:

a) Prove that the regulations are being met

b) Articulate the Investor Benefit Matrix previously described
c) Explain the derivation of the research budget numbers
d) Demonstrate how the asset owner's di minimis research spending directly supports the mutually agreed mandate investment objectives

…will stem from the analysis we have above.

Client Risk Mitigation

Frost is happy to discuss the specifics of proven risk mitigation strategies directly with managers.

As part of the ongoing Asset Manager/Asset Owner relationship, there should be a system to allow Asset Owners to "Trust but Verify", leading to the next section.

Research Value Assessment Framework

Benchmarking

Under new UK research rules, benchmarking of research spending is required. It is also recommended as "Best Practice" by the Healthy Markets Association which was one of the authors of the letters to the SEC on research transparency.[2]

For asset owners the most relevant research benchmarking is related to fund or strategy-level research spending – specifically, the ones in which they are invested. Typically, asset owners are less interested in manager spending on individual research products.

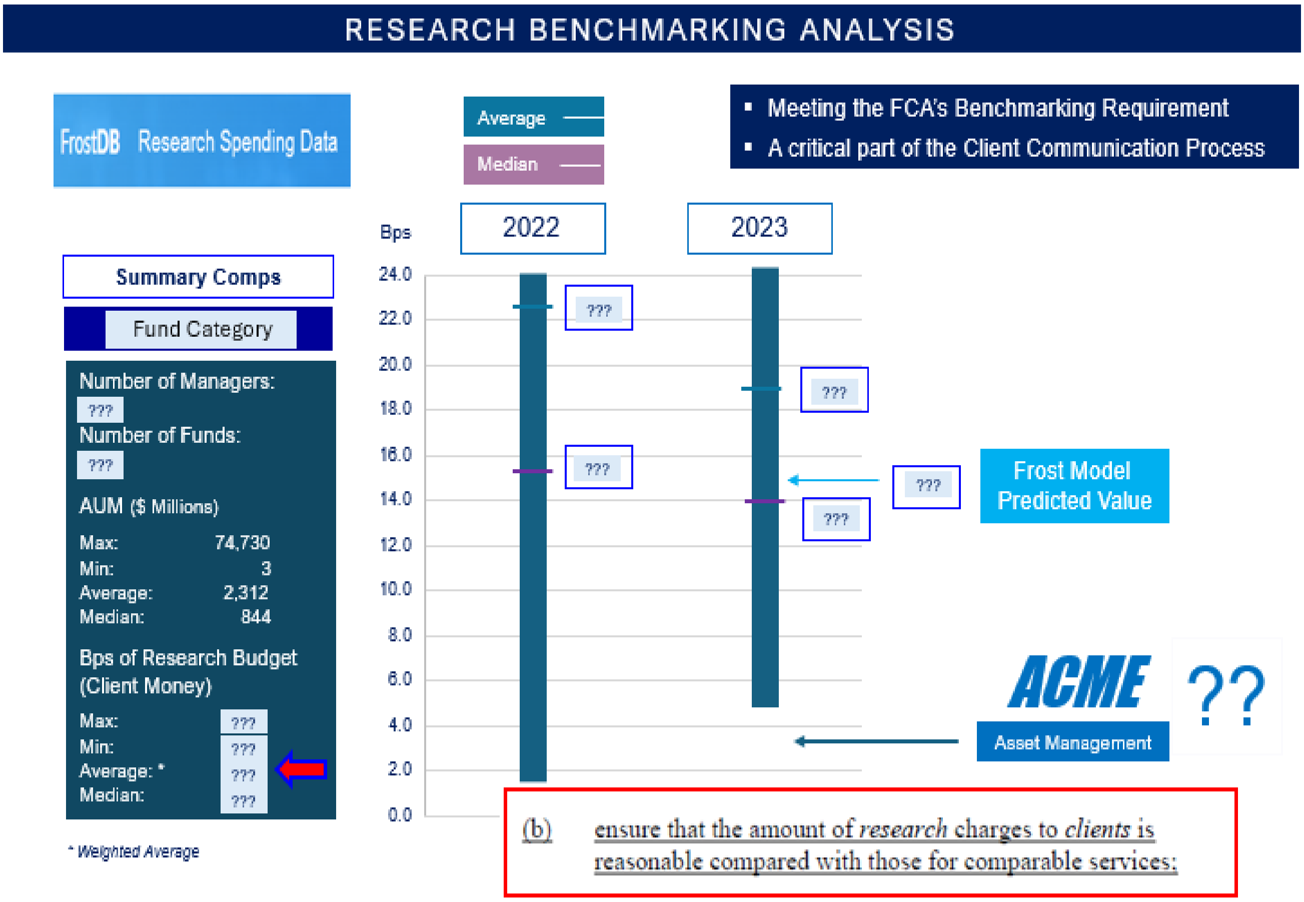
Frost has a database designed specifically to compare research spending (as basis points of AUM) between like-for-like strategies, i.e., Emerging Markets, Global Growth etc.

* Indicative Categories

Global	US	Europe	UK	EM	Asia	Sectors
Global Equities	US Equities	Emerging Europe	All Companies	CEE	Asia Equities	Biotech
Global Large Cap.	US Large Cap	Equity Income	Smaller Companies	EM Asia	Asian Ex-Japan	Commodities
Global Small Cap	US Mid-Cap	Europe ex-UK	Equity Income	EM Small Cap	China	Consumer Cyclicals
Global Mid Cap	US Small Cap	France	Direct Property	Global GEMS	China Small Cap	Consumer Staples
Global Growth	US Large Cap Growth	Germany	Value	Latam	Equity Income	Energy
Global Value	US Large Cap Value	Italy	Growth	MENA	Hong Kong	ESG/SRI
Global Financials	US Value	Netherlands			India	Financials
Global Equity Income	US Growth	Nordics			Indonesia	Heathcare
	US Small Cap Growth	Pan-Europe			Japan	Industrials
	US Small Cap Value	Spain			Japan Small Cap	Media
	US Core	Switzerland			Korea	Precious Metals

Asset owners want to ensure that manager research spending is reasonable and appropriate for the strategies in which they are invested. Asset managers should seek to ensure that product research budgets are giving their investment teams the opportunity to be globally competitive.

The graphic below illustrates the type of comparative strategy research spend benchmarking that can help managers meet regulatory requirements and assure asset owners that manager research spending is reasonable versus comparable funds.



P&L managers may have the ability to actually raise research spending to enhance the global competitiveness of their investment teams and still look very competitive relative to US managers. This process not only meets the UK benchmarking requirement, but forms a critical part of the client communication strategy.

Because P&L managers have had no regulatory requirement to disclose research spending, asset owners may not realize just how low research spending is, especially compared to other fund cost items and the research spending level of US managers.

[2] Healthy Markets Association Asset Manager Research Questionnaire: https://bit.ly/3VyuTNL

Academic Validation and Quantitative Models

These topics have been discussed in previous sections of the paper but form important parts of a coordinated and consolidated approach to demonstrate to asset owners the derivation of manager research budgets, and more importantly, how this spending directly supports the return objectives of the asset owner.

Cross-Subsidization Control

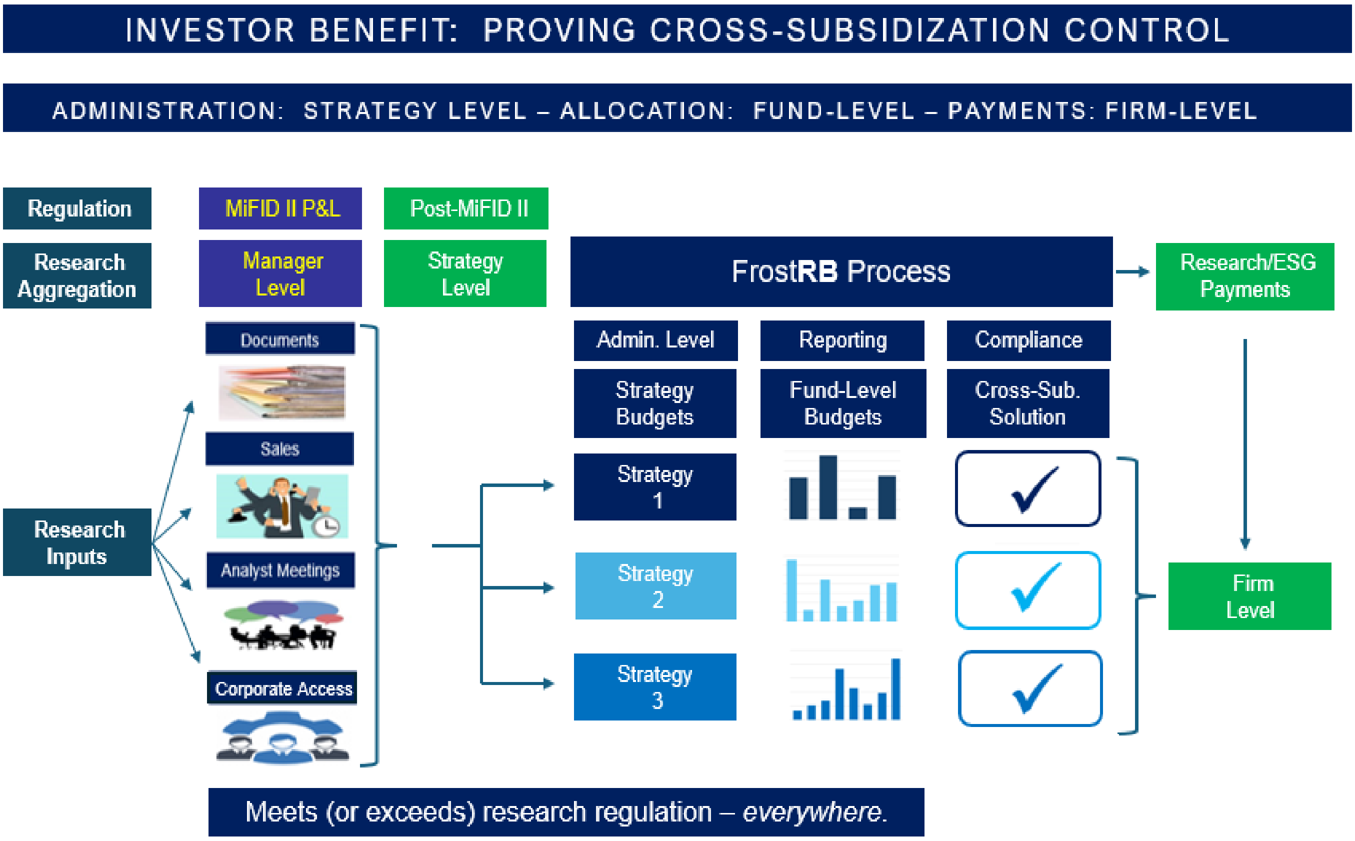
Cross-Subsidization control has emerged as a central, and understandable issue for asset owners when managers are using their money for research.

Clearly, from a Fiduciary perspective, asset owners should not be purchasing research services with beneficiary funds that are not pertinent to the strategies in which they are invested.

The challenge for asset managers is that many funds will use the same research services which raises questions about how to fairly divide these costs.

Based on previous academic work, Frost has developed a methodology that can guarantee and demonstrate "iron-clad" cross-subsidization control.

The key principle is, that every fund or strategy that uses a research service pays for it, although it may pay a different amount from another fund for which the service was more or less valuable based on the client outcome in that product.



This differs from the common MiFID II P&L approach of valuing research services at the firm level. Unless all of a manager's clients are equally weighted amongst all of its funds, the firm-level valuation approach is not consistent with the new UK & EU rules and with the recommendations of the Council of Institutional Investors and CFA Institute in the US.

Frost systems can de-construct client research payments down to the last penny and demonstrably prove that each fund/strategy is paying for research services separately – and appropriately.

Risk-Reward Analysis for Manager Executive Committees

The widespread move to UK/EU managers to fund research via P&L in 2018 was a competitive response to the large US managers that precipitated this outcome – this despite the fact that most UK/EU managers had planned to continue to use client money for research post MiFID II.

Although new UK/EU research regulations are making it easier for asset managers to charge clients for research (by informing them of research budgets at the mandate level rather than requiring their consent), many managers are hesitant to be the "first mover".

While the fear of client reaction has dominated the industry discussion, we would note that:

a) Frost has worked with multiple managers to successfully make this research funding transition without adverse client consequences

b) Frost can identify more than 30 managers that currently charge UK/EU asset owners for research (and remain in business with large numbers of clients).

Risk	Impact	Duration
Client Risk	Med./Low	Short-Term
Earnings Risk	Very Low	Short-Term
Operational Change	Low/Medium	Short-Term
Regulatory Risk	Very, Very Low	N/A

Benefit	Impact	Duration
Profitability	Medium	Long-Term
Competitiveness	High	Long-Term
Inv. Team Retention	High	Long-Term
Inv. Performance	Medium	Long-Term
Inv. Culture	High	Long-Term
Global Op. Model	Medium	Short/Long Term
Franchise Value	High	Long-Term

Frost has worked with multiple asset manager executive committees to consider a balanced analysis of the risks and rewards of making the research funding transition.

While client risks cannot be entirely eliminated, based on our experience and battle-tested Client Communication and Risk Mitigation strategies, we believe that client risks can be effectively managed.

Additionally, we are confident that regulatory and operational risks can be reduced to very low levels.

What managements rarely focus on are the benefits on the right side of the chart. In our view, the risks are short-term and transitory, while the benefits compound over the long-term and can have a material impact on the medium-term enterprise value of the asset management franchise. Executive committees of asset managers should not be managing their businesses based on outcomes in the next quarter. Their responsibility is to create long-term value.

The research funding question is really quite simple:

Which of the two research funding methods …..

- Manager P&L

or

- Client Funded Research

……maximizes the probability that the manager can generate competitive returns for clients and shareholders over the long-term – and regardless of market conditions?

We believe that it's prudent for asset manager executive committees to consider whether to accept some calibrated short-term client risk in order to achieve the long-term benefits on the right column of the graph.

(Frost has customizable models that can actually quantify the risk-reward framework above).

Why Doing Nothing Is Not a Risk-Free Option

A common belief, particularly amongst P&L asset manager client service teams, is that doing nothing (i.e. maintaining the current research via P&L methodology) is a risk-free option. Many fear that any discussion with clients related to applying small research charges would entail significant risk and open up conversations on fee structures in general.

In our view, there are multiple risks inherent in doing nothing.

1. General Market Shift Back to Client Funded Research

As per the Institutional Investor survey graph on Page 5, currently a quarter of managers definitively plan to return to a client-funded model, with another 35% (at least) poised to follow rapidly.

Given the desire of UK/EU governments and regulators to place their domestic asset management businesses (and their clients) on a more competitive global footing and the desire of many UK/EU asset managers to have greater research spending flexibility, we think the industry outcome will not be 50/50.

A widespread move back to a client-funded model is the most likely scenario. This will have important second order effects.

2. Rising Research Pricing.

If there is a widespread move back to client money, research pricing will rise, particularly in the UK/EU where it has been depressed by the widespread use of manager P&Ls for research spending.

US managers using client money for research are paying far more than their UK/EU peers. This gap will almost certainly narrow in a client-funded research environment. This places managers funding research via P&L at an increasing disadvantage as they are "priced out" of the research market.

3. Market Risks to Research/ESG Budgets

As explained earlier, P&L manager research/ESG budgets will continue to be exposed to unforecastable and potentially volatile market risks.

4. Increasing Application of AI Models in the Investment Process

This is perhaps the greatest risk given the profound implications for asset manager productivity. Most asset managers were initially reluctant to expose their investment processes to AI models owing to concerns about the validity of model outputs.

However, recent advances in dedicated asset management AI processes are solving many of the initial problems. There is a growing acceptance of the potentially existential nature of this technological shift. Active strategies that ignore this transition are at risk of having a "Kodak Moment".

As asset owners, fund selectors and regulators ask more pointed questions about AI integration into the manager investment process, it will become clear that participation is not optional.

Conclusion

Frost has proven that managers can successfully return to a client-funded research model with limited asset owner impact.

Frost is happy to work with all of the firm's management teams, including Client Service, to ensure a successful transition. It can be done. One of the critical factors is providing the Client Service teams the data and analysis they need to effectively engage with clients.

Frost Research Systems has been at the forefront of industry discussions on research spending and regulation for more than a decade and through multiple regulatory regimes.

What has been missing from this seemingly endless research debate is a clear, objective assessment of risk and reward —rather than the familiar clichés and "received wisdom" put forward by business units with limited perspective – departments whose job is not to maximize the value of the asset management franchise over the long term.

It is up to senior management and executive committees of asset managers to balance the risk, rewards and opportunities of this new regulatory environment for the long-term benefit of clients, shareholders and wider society.

This comes at a critical juncture as AI is about to transform the competitive landscape.

Appendix

Historical Context

The introduction of MiFID II in 2018 fostered an unfortunate and unnecessarily adversarial conversation between asset owners and asset managers on research costs - which are very de minimis relative to the range in fund returns.

The widespread move by UK/EU managers to fund research via P&L did not sufficiently consider the relationship between research cost and value.

Consequently, asset owners achieved tiny "apparent savings" resulting in sub-optimal returns (of far greater magnitude) and a manager research funding system with significant unintended market risks.

The primary MiFID II research objectives were to:

a) Increase research transparency for asset owners

b) Augment asset owner returns by eliminating excess manager research spending

MiFID II failed utterly on both counts, which explains why UK/EU governments/ regulators are reversing this as quickly as possible (and explains why the US never had any intention of following this path).

The widespread move by managers to fund research via P&L actually eliminated asset owner research transparency as there was no regulatory requirement for them to report changes (huge reductions) in research spending.

And, while the objective of lower manager research spending was certainly met, it had the opposite than intended effect on asset owner returns.

Unintended Market Risks

In the run-up to MiFID II start date of Jan. 1, 2018, most large UK and EU managers publicly announced that they planned to continue to use client money for research despite the fact that there was additional regulatory complexity involved as a result of MiFID II.

In the fall of 2017, 3 large US global managers announced that they would pay for research via P&L (for their UK/EU clients only). The bulk (95%) of the global research budgets of these US managers would still be funded by US asset owners, who they continued to charge for research.

This provoked an almost universal knee-jerk reaction amongst UK/EU managers to also suddenly move to P&L for research for fear of negative client reaction if they failed to do so. (This was not a forgone conclusion). The difference was that for the UK/EU managers this affected ~90% of their assets under management versus ~5% for their US competitors.

This placed UK/EU managers at a substantial funding/information disadvantage.

What regulators failed to realize was, that while research costs for asset owners (deducted from fund returns), were very low (a handful of basis points versus average annual returns ~700 Basis points), for asset managers research costs were very high. For most managers this was their second biggest cost – just after staff compensation.

This created an unhelpful conflict between buying optimal research for the client and maximizing the profitability of the asset manager.

Active manager margins had been under pressure for some time with the emergence of passive products. The widespread move in the UK to fund research from asset manager P&Ls exacerbated this margin compression.

Many observers (ourselves included) estimated that research spending by UK managers funding research via P&L has declined by ~75% since pre-MiFID levels. While in theory this created small savings for asset owners, there is evidence that this hurt their asset owner returns far more.

Is this system in the best interests of asset owners? They must weigh “savings” of a couple of basis points in research cost against performance differentials between funds that are frequently thousands of basis points – and simultaneously accept significant market risks.

Unforecastable Market Risk

It is sheer coincidence that the two most recent sudden market declines, COVID in Spring 2020 and Liberation Day in April 2025, happened in the first half of the year. In both cases markets rebounded substantially by year end, mitigating the potential impact on subsequent year research/ESG budgets for P&L managers.

However, if such a decline occurred during the fourth quarter, subsequent year research/ESG budgets could have been severely compromised.

This highlights the continuing differences between the US and UK/EU systems. During the COVID decline, research budgets in both US and UK/EU managers were dramatically impacted, but in opposite directions.

In the UK/EU sudden market/AUM declines could potentially feed through to research budgets as they are financed by the pre-tax profits of P&L managers. During COVID markets dropped by ~20% in a couple of weeks, with a corresponding effect on asset manager revenues. (No manager could cut costs that quickly).

By contrast, the main driver of research budgets in the US is equity trading volume as it is still (primarily) a bundled commission market. While equity indices sharply declined during COVID, portfolio turnover in the US increased by ~40%, significantly *increasing* US manager research budgets.

This differential was compounded in 2023 when the SEC declined to extend the SIFMA MiFID II No Action Letter that temporarily allowed US investment banks to accept hard dollar research payments from MiFID II scope managers without registering as Investment Advisors under the Investment Advisors Act of 1940 – something most US investment banks want to avoid.[3]

From a trans-Atlantic regulatory and commercial perspective, we have made a round-trip on MiFID II research regulation. Governments and regulators have played their part in terms of making the transition back to client-funded research easier.

Asset managers must now take the next steps by developing sufficient confidence in their research valuation processes and associated communication strategies to position their clients and shareholders to prosper in the long-term.

4. US banks that register as Investment Advisors under the 1940 Act are prohibited from engaging in principal trading – a revenue source for the US banks that vastly exceeds research revenues from MiFID II-scope asset managers – by a factor of ~ 300X.

Frost Research Systems

124 City Road,
London, EC1V 2NP

www.frostresearchsystems.com www.frostrb.com info@frostresearchsystems.com