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Research Transparency American Style – Saving the 'Safe Harbor'

Neil Scarth

Frost Consulting

Ensuring transparent strategy-specific research spending is in everyone's interests. But the US will evolve its own style of research transparency. This will be higher than the current standard, but potentially without the corrosive and unanticipated consequences of MiFID II in Europe.

Recent statements from the SEC, together with recommendations from US asset owner associations and other industry bodies, suggest that the US will maintain the "safe harbor" research commission system – with the caveat of greater asset manager research spending disclosure.

The US will evolve its own style of research transparency. This will be higher than the current standard, but potentially without the corrosive and unanticipated consequences of MiFID II in Europe.

This could be an ideal outcome for US managers globally – giving them the option of maintaining robust research budgets to ensure the continuity of their historic investment process in order to support investment returns in return for greater transparency.

The advent of MiFID II research provisions has sparked a debate in the US regarding:

1. Whether the SEC would follow Europe's lead on research regulation;
2. Whether all or most US/global managers would move to P&L globally regardless of regulatory requirements; and
3. The ultimate attitude of US asset owners toward the research commission system.

We're close to getting answers, with the direction of travel increasingly clear. Recent indications from the SEC suggest that they are cautious about MiFID II-style research regulations for three key reasons.

The first relates to the vibrant sell-side research ecosystem that allows risk capital to fund what, in some cases, become leading global companies. Example: In Amazon's IPO in 1997, the company sold 3 million shares at $18 each, to raise $54 million, giving it a market cap of $438 million. Amazon was a small-cap stock (Mid-Cap stocks start at ~$2 billion). Other IPO valuations of note: Apple - $1.2 billion; Microsoft - $750 million.

The SEC potentially believes that the wealth created by this research ecosystem may outweigh a handful of basis points of research costs for asset owners, particularly if it funds the research which is vital to capital formation.

The second reason concerns the competitiveness of smaller, or even mid-sized, asset managers. The widespread move to fund research via P&L in Europe has created economic pressures for all managers, with size being an important determinant of the magnitude of the decline in manager profitability.

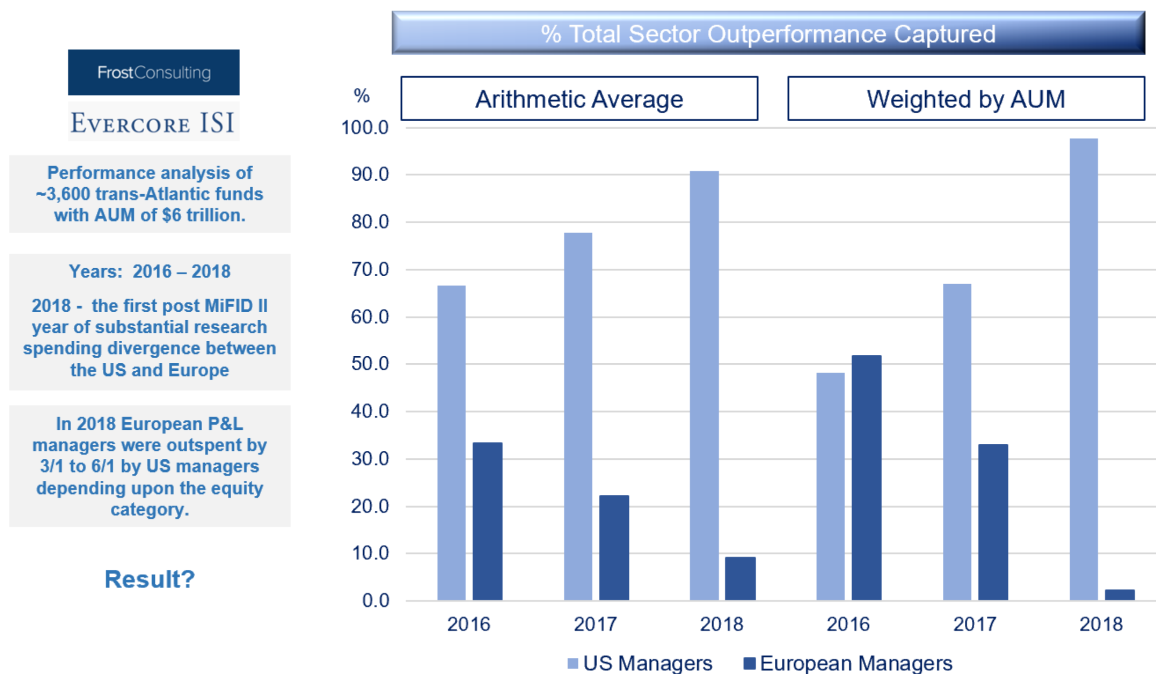
While research costs are very small for asset owners, when this charge is moved to the P&L of the asset manager, it is frequently the largest cost after staff compensation. This creates tension between the potentially conflicting objectives of purchasing the optimal research for the investment strategy and maximizing the profitability of the manager.

Credit Suisse estimated that, on average, P&L managers in Europe cut research budgets by 50% between 2017 and 2018, when MiFID II began. A recent Liquidnet study suggested P&L managers in Europe had cut between 20% and 70% of their research counterparties.

The FrostDB research spending database has revealed enormous gaps in research spending between:

- Managers using P&L and those using client money;
- US managers and European managers; and
- P&L managers themselves.

An analysis by Frost Consulting and EvercoreISI found that a large sample of European funds (primarily P&L) had significantly underperformed US managers (primarily using client money for research) across 15 equity categories in 2018. This was the first year of a substantial differential in research spending between Europe and the US.



While there are many variables influencing performance, an unprecedented divergence in research spending among US and European managers was likely a contributing factor.

The research funding issue in the US has also been highlighted by the decisions of a handful of large US asset managers to fund research via P&L in the US, even in the absence of a regulatory requirement to do so – and in the face of significant related administrative issues.

The SEC appears to be unenthused about the prospect of managers funding research via P&L given the fact that a) research spending tends to decline, and b) research costs for asset owners (a handful of basis points) are clearly dwarfed by the performance differential between funds that do well and those that do poorly.

In the Frost/EvercoreISI study, the average differential between mid-first and mid-fourth quartile performance in 2018 over 15 equity categories averaged 1,300 basis points – a huge multiple of any conceivable research budget.

Another anomaly relates to the fact that many US managers fund research via P&L for their clients in Europe but continue to use client money in the US.

In late June, two US pension fund organizations (Council of Institutional Investors/Healthy Markets) and the CFA Institute wrote a joint letter to the SEC recommending they maintain the current commission system but asking the regulator to require further asset manager research spending disclosures.

Specifically, the groups asked that asset managers using client commissions for research should be able to demonstrate that a client's research spending benefited *its specific portfolio*. This would require asset managers to identify client research spending (likely down to the fund level) and associate it with research relevant to the investor's portfolio – demonstrating that the client was not subsidizing other investors.

This fell well short of demanding that managers move to P&L. (Perhaps US asset owners were conscious of the potential performance implications, having watched MiFID II unfold in Europe).

This approach was echoed in the recommendations of the SEC Investor Advisory Committee. It is expected that the SEC will respond within weeks.

This would be a welcome outcome. Frost argued in a paper with Stanford University that asset owners and asset managers should *collaborate* on research budgets. Why? Because both parties want the manager's investment product to achieve its targeted returns.

Hopefully these initiatives will be part of that collaborative process. Although this will require US asset managers to do more detailed research valuation/budgeting/attribution, it is a small price to pay in return for the ability to continue to use client money to fund robust research budgets.

(*The FrostRB research valuation platform is uniquely designed to align benchmarked strategy-level research budgets to specific investment mandates, increasing transparency and solving cross-subsidization issues*.)

For US asset managers, this is vastly preferable to being forced to manage the conflicts of interest inherent in the P&L research model.

European asset managers resisted research transparency. The result was adversarial regulation (MiFID II) combined with an alarming competitive reaction (P&L), particularly for small and mid-sized managers.

The SEC and US asset owners are offering US managers the opportunity to make a better decision – for themselves and their clients.

Ensuring transparent strategy-specific research spending is in everyone's interests. It supports investment returns for asset owners and maintains the profitability and competitiveness of US asset managers.