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BNP Asset Management's MiFID II Research Budget Transparency: A Global Competitive Challenge?

BNP Asset Management's decision to release MiFID II research budgets to all of its global clients, not just those covered by MiFID II, may be a competitive inflection point for the industry. While BNP Asset Management had no legal/regulatory requirement to present those budgets globally, it presumably concluded that extending transparency to all of its clients on an equal basis would be a competitive advantage. And a major global asset manager releasing detailed research budgets will inevitably introduce significant fiduciary questions for institutional investors about their other managers' research spending.

BNP Asset Management's decision to release MiFID II research budgets to all of its global clients, not just those covered by MiFID II, may be a competitive inflection point for the industry – one that may permanently alter the interface between asset owners and asset managers.

[Related: "The Financial Services Industry's Darwinian Moment – MiFID II Focus Shifts to Excellence"]

A major global asset manager releasing detailed research budgets will inevitably introduce significant fiduciary questions for Institutional Investors. Asset owners routinely measure trade costs (via TCA) but historically have paid little attention to research costs – despite the fact that research commissions are twice the size of execution commissions and *account for ~90% of portfolio returns. **

The obvious question will be: "How does this research spending compare to the asset owner's other managers – regardless of their geographic location and local regulatory framework." An asset owner's fiduciary responsibility to its stakeholders is not altered, or in any way diminished, by the domicile of their underlying managers.

By January, MiFID II will require asset managers to present proposed research budgets to asset owners, based on the specific investment products they hold across all asset classes. This is a significant challenge for complex asset managers. Many asset managers (outside the UK) have not had ex-ante research budgets at the firm level, let alone deconstructing them down to strategy or fund basis. Furthermore, both asset owners and regulators are increasingly aware that not all strategies require the same amount of research or size of research budget.

MiFID II regulated managers will have to construct a framework of multi-asset class research strategy budgets across the firm that will allow research costs to be fairly allocated to clients. MiFID II bans cross-subsidization, meaning that every fund that consumes research should pay for it, representing another complex challenge for large managers where research services are used across multiple products.

[Related: "FCA's Policy Statement: 5 Key Points Regarding Research"]

While BNP Asset Management had no legal/regulatory requirement to present those budgets globally, it presumably concluded that extending transparency to all of its clients on an equal basis would be a competitive advantage. All global firms subject to MiFID II that plan to use client money for research will have to decide whether to follow suit.

The timeframe before MiFID II implementation is shrinking rapidly. For many asset managers, the primary initial MiFID II focus was on how to get the CSA/RPA process to work. BNP's decision is a timely reminder that the payment process is only part of the equation. The far greater challenge will lie in demonstrating to asset owners how proposed research budgets directly support their investment objectives – or potentially have their research budgets rejected, requiring the manager to pay for research via P&L.

An additional complexity for asset managers is that they will have no idea of how competitors will construct their research budgets (strategy-level, fund-level, size of budget), particularly in similar products.

European asset owners will receive a flood of incoming research budget proposals from asset managers beginning in 2H 2017. BNP's decision may make this a global phenomenon.

This raises key questions for asset managers subject to MiFID II that are planning to use client money for research (and those that compete with them). These include:

1. How will we assign potentially thousands of funds/products into strategy budgets that fairly reflect research use (and who at the firm will do this)?
2. How will we determine the "research intensity" of each strategy budget to determine how large the research budget should be? (The size of the research budget must be communicated in advance to the asset owner.)
3. How will we develop a "research valuation methodology" that can be explained to clients, both in terms of the size of the research budget and how we value unpriced research services from investment banks. (The methodology will have to extend beyond short-term product consumption [documents/meetings] because they cannot be forecast a year in advance.)
4. How can we align research budgets with specific investment processes/products agreed with clients and meet the MiFID II requirement of "demonstrating research value to the portfolio"?
5. How will we construct multi-asset-class research budgets?
6. How will we find a solution for cross-subsidization and be able to prove this to clients and regulators as part of detailed ex-post MiFID II reporting requirements?
7. How (and when) will we develop the MiFID II required Written Research Valuation policy which explains how we value research and how we fairly divide research costs between clients?
8. How will we meet the FCA requirement of noting substantive research interactions without deluging our investment professionals in time-consuming bureaucracy?

A number of firms have gone through extensive RFP processes to choose systems to help with MiFID II research challenges. Some that have focussed primarily on the payment mechanism have realized, with the benefit of 20/20 hindsight, that their new systems do not address the key questions above – in short, they may do many things, but they don't value research – the central requirement of the new regulation.

With only months before MiFID II, the manager suddenly realizes that they have made no progress in solving the (very challenging) issues of constructing research budgets, figuring out how much they should pay for research – and how to justify that to clients and regulators.

An asset manager's ability to explain how the proposed research budget will support the asset owner's investment objectives will be central to budget approval. The research valuation/budgeting methodology and its alignment with the investment process will be the key.

(Few asset owners will approve MiFID II research budgets based solely on the slickness of the manager's CSA/RPA payment mechanism – particularly in the absence of a coherent explanation as to how the research budget was constructed and how that will benefit the client's portfolio.)

For those managers whose current internal processes, or external systems, do not address the key questions posed above, BNP has provided a timely competitive wake-up call to senior management to rapidly focus on finding answer