Global Research & Risk Solutions

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Research re-bundling may be a step too late

Bundling may be back, but the market has evolved

Point of view | June 2024

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Executive summary

At first glance, the UK Financial Conduct Authority's (FCA's) recent proposal on re-bundling appears positive, as it aims to address the damaging impact of the Markets in Financial Instruments Directive (MiFID) II unbundling rules on investment research.

However, the market has evolved since the rules came into play, and it is probably too late to reverse the structural changes that have become ingrained post MiFID II.

Conversations we have had with our clients since the FCA proposal also corroborate this conclusion.

Key takeaways:

- Asset managers have become more discerning about the value of research they consume from the sell-side. They have bolstered their internal research teams and increasingly leverage primary and alternative data to drive their decisions. This is unlikely to change.
- Asset managers have put in place mechanisms to ensure compliance with unbundling rules. With the European Union (EU) still sticking with unbundling, managers may want to avoid the operational complexity that comes from maintaining different payment systems for the UK and the EU.
- Finally, and perhaps most importantly, the dynamics between asset owners and asset managers have changed since MiFID II. With most managers absorbing the cost of research on their P&L, asset owners are used to not paying for research. Will they now agree to start paying for research post re-bundling? Seems unlikely.
- For sell-side firms, this would mean the trend of shrinking budgets will likely persist, and they would have to continue to prove the value of their research to get paid for it.

FCA proposes to roll back MiFID II unbundling rules

In April this year, the FCA unveiled a consultation paper proposing that asset managers should be able to bundle charges for investment research with charges for execution. The FCA said the move will empower asset managers to choose how they pay for research, boost competition, increase transparency and make it easier to buy research across borders.

However, this is not a full reversal of the pre-2018 bundled regime. Rather, this is an option provided to asset managers, subject to fulfilment of certain requirements — which the FCA calls ‘guardrails’— to ensure investors are protected. These guardrails include having a formal policy, assessment of research value, approach for apportioning costs to clients, client disclosures and so on.

Here’s some background to understand how we got here.

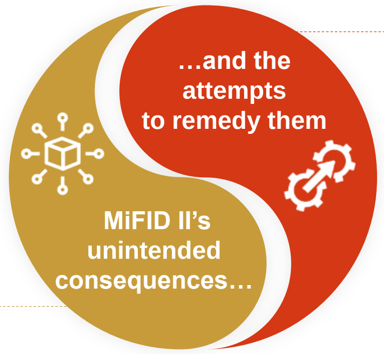
Timeline of MiFID II and its amendments

	January 2014	October 2017	January 2018	February 2021	November 2021	December 2022	July 2023	April 2024
EU	In-principle agreement reached on MiFID II rules		MiFID II rules come into effect	EU allows bundling for companies with market cap < €1 billion		EU proposes bundling for companies with market cap < €10 billion		
UK					FCA allows bundling for companies with market cap < £200 million			FCA proposes bundling for all companies
US		SEC issues “No-action” relief					SEC “No-action” relief expires	

Source: CRISIL GR&RS

The unintended consequences of MiFID II and attempts to remedy

- **Decline in research spend by the buy-side** driven by more internal research, and efficient consumption of external research. As per an FCA survey, external research spending fell 36% from 2018 to 2023.
- **Reduction in research coverage and research quality,** especially of small- and medium-sized stocks, as there was a decrease in the number of sell-side analysts and 'juniorization'. This perception has come through in an FCA survey and echoes what we heard from our buy-side clients.
- **Smaller asset managers are at a competitive disadvantage** as they do not have the financial capacity to absorb research costs in their P&L, unlike the larger managers



- **The EU and the FCA recognized these issues and reversed unbundling requirements partially in 2021** — for companies with market capitalization less than €1 billion in the EU and £200 million in the UK.
- **But these changes did not have a meaningful impact,** as asset managers did not want to deal with operational complexity and continued with the unbundled approach for all stocks.
- **Hence, this FCA proposal on re-bundling for all companies,** as well as an earlier EU proposal allowing re-bundling for companies with market capitalization below €10 billion.

The contrast with the US

In the US, bundling or 'soft dollars' is the norm. Further, US regulations prohibit broker-dealers from accepting research payment separately ('hard dollars'), unless they register as investment advisors. That said, the US broker-dealers have not been in favor of such a registration, as it involves additional compliance and operational burdens.

For the market to adjust post MiFID II, the Securities and Exchange Commission issued a 'no-action letter' in October 2017 that allowed broker-dealers to accept unbundled payments for research without registration. However, this 'no-action letter' expired in July 2023.

To continue receiving payments from UK and EU asset managers, broker-dealers in the US would have to (a) register as investment advisors, with its associated compliance overheads, or (b) set up research payment accounts, which can be administratively complex, or (c) provide service through their UK and EU affiliates, which may not be possible for all, or (d) stop providing research to UK and EU managers.

While the FCA's consultation paper suggests that evidence of negative impact from this expiry is limited, this issue would be rendered moot if the current proposal allowing re-bundling gets implemented.

The FCA's consultation on the latest proposal closed on June 5, 2024, and it aims to publish the final rules shortly.

We believe the FCA's move has come too late

While the FCA's proposal is well-meaning, our view is that the market has evolved, and it is probably too late to reverse the structural changes entrenched post MiFID II. Specifically, we see three aspects that drive the impact.

Value of research

Buy-side more discerning about the research it pays for

As most managers pay for research from their P&L, they demand high quality and differentiated ideas. On the sell-side, this means only firms that provide differentiation will reap the benefits.

Asset managers have bolstered in-house research

With larger internal research teams — both onshore and offshore — and increased usage of primary and alternative data, asset managers are less reliant on external research.

This is a trend we have observed first-hand over the past few years — our roster of buy-side clients has grown, and so has the average size of each engagement. Re-bundling is unlikely to reverse this as assessing the value of research is now ingrained in the buy-side.

Operational complexity

MiFID II compliance mechanisms are complex but help assess value of research, and are not easy to dismantle

Hence, most asset managers continued to follow unbundling despite partial relaxation by the EU and FCA for small-cap companies

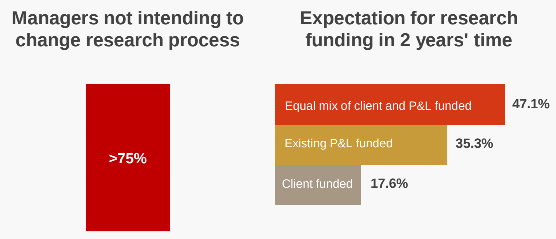
FCA's re-bundling proposal has guardrails to be adhered to by asset managers, which could be operationally onerous

Half of the managers surveyed by the FCA were undecided/unlikely to use the re-bundling option, regardless of the details of the guardrails. In our discussions with clients, we noted a similar reluctance to change due to the operational complexity involved.

Commercial dynamics

Asset owners are used to not paying for research. Will they start paying post re-bundling, based on the promise of higher-quality and broader research?

Competition among asset managers, experience of managers who decide to bundle, and views of large investors will be key determinants



Source: Substantive Research, a buy-side spend analytics provider

Early indications from our client conversations point to a similar uncertainty but with a propensity to stick with the current P&L-funded model.

Conclusion

In our view, the FCA's proposal, though well-meaning, has come in too late to reverse the structural changes that have become entrenched post MiFID II.

Asset managers are focused on the value of research. They have expanded their internal research teams and are likely to be reluctant to take on more operational burdens.

Finally, commercial dynamics between asset owners and asset managers would be the key determinant of who would shoulder the cost of research. We think it would likely continue to be the asset managers.

For sell-side firms, things are likely to remain the same — they would have to prove the value of their research to get paid.

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