The Changing Face of Equity Trading:

Paying for Research

The traditional method in Europe of paying for research through client commissions is set to be redefined out of all recognition. Some perceive that the use of commissions has been open to abuse through obfuscation and lack of clarity on fees. The proposed radical overhaul of how research can be obtained and paid for throws the debate wide open as to how research will be consumed in the future.

Confusion reigns as to exactly how the MiFID II Level II text should be interpreted given the differing stance by European regulators. The FCA states all research has to be contracted and paid for separately and Commission Sharing Agreements (CSAs) in their current form are no longer valid. Other European regulators take an alternate view: If any link of research payments to turnover is no longer admissible, what will be the consequences of such change? There are very real concerns among both buy- and sell-side firms that these new regulations will sound the death knell for small and mid-cap trading and capital raising by small firms. Larger firms may well have the advantage by virtue of having deeper pockets to purchase research and employ their own analysts. Will this benefit the end investor? Regardless of the final time line and exact requirements, changes to how research is both generated and paid for will require the industry to establish a method of both evaluating and pricing research.

TABB spoke with 51 Global heads of trading in January 2015 to establish their views on the proposed regulation; how they plan to adjust internal procedures to meet the new regulations; and what these changes will mean for the changing face of equity trading.

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Key Facts

1. Buy-Side traders anticipate current unbundling proposals will hit research payments to global investment banks as firms scrutinize the quantity and quality of what they receive; 67% of participants believe that research payments will decline.

2. Continental European firms envisage a greater impact, with 86% of firms anticipating a decline in research payments. However, 35% of UK firms see a flight to quality research rather than an outright decline in usage.

3. Seventy-nine percent of participants foresee that smaller asset managers will be at a disadvantage as a result of the proposed changes; including 75% of larger asset managers and 79% of medium sized asset managers.

4. Regulators want the industry to unbundle research payments from execution commissions to benefit the end investor, however unbundling is already underway in Europe: 58% of participants now have a budget target for research payments, and 55% anticipate switching to execution-only commissions once the target has been reached.

5. Sixty-eight percent of participants are in conversations with their brokers regarding the cost of research, but 56% are dissatisfied with the progress so far. Few on the sell side are perceived to be providing the required pricing points yet.

6. Regulatory confusion between European national competent authorities is now beginning to hamper progress. Thirty-eight percent of UK firms and 30% of all respondents are now sitting on the sidelines unsure of what to do next.

7. Over 90% of participants see mandated CSAs as a potential solution to the regulatory deadlock, however this includes 20% who recognise they are only part of the solution in increasing transparency over fees.

8. Fifty-nine percent of participants assume that firms will be unable to increase fees in the current competitive environment; 46% see the forced absorption of any increase in fees as having a direct negative impact on their firm.

9. While commoditized access to algorithms will continue to reduce low touch rates, 44% of participants believe execution fees will also come under scrutiny as firms anticipate the provision of menu pricing for execution as well as research.

10. Although a global commercial solution to pay for research needs to be found, 48% of participants felt the interest to invest in Europe currently was sufficiently robust not to materially impact investor appetite at this stage. However, a third believed the impact would be negative.

Table of Contents

Table of Exhibits

Executive Summary

The looming pensions crisis in Europe is shifting the spotlight from the sell side to the buy side to account for current practices in the consumption of research. Opacity and confusion over costs and fees has led some to believe that the use of dealing commissions to purchase research is fatally flawed. On the back of a string of financial services scandals, such views are understandable, but hardline responses rarely deliver intended results.

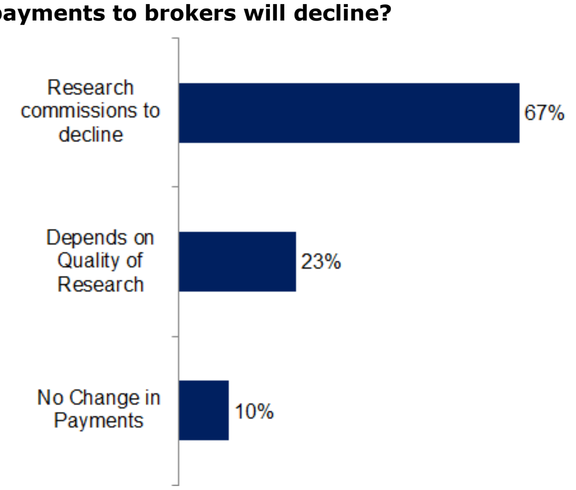
The end objective of improving transparency and achieving value for money for investors is without question. Few would disagree of the necessity to break the monopoly of research provision by global investment banks in order to encourage competition, or even that more could be done to improve the research payment process. What is questionable however is whether the perceived decline of research consumption is an inevitable or advisable outcome; and if this outcome will benefit the end investor in the longer term.

The reality is that dealing commissions is yet another area of financial services where the industry is undergoing painful metamorphosis. Constrained resources and greater accountability have already created demand for an improved understanding of costs versus profitability. The sell side is becoming more selective of what they provide, while the buy side is being more discerning of what it chooses to consume and how this is paid for. However, regulators have lost patience with the perceived limited progress the industry is making and is now ratcheting up the legislation.

It was once a simple process. Asset managers would receive research from their brokers in order to make the most appropriate investment decision for their clients. Any subsequent transaction was then passed to the broker who added fees for providing the research on the back of the cost of executing the trade.

The risk with the bundled model is that fund managers may or may not receive best execution if they are automatically routing orders to favoured providers of research. Nor is there any guarantee that the fund in question is paying for the correct level of research. Cross subsidisation among funds and firms may lead to end investors paying for services they did not use. There is a (mis)perception that funds may be encouraged to trade more than necessary in order to "pay" for research, although heads of dealing desks would refute this given the internal processes now required ahead of placing a trade.

Exhibit 1
What is the likelihood that your total research payments to brokers will decline?



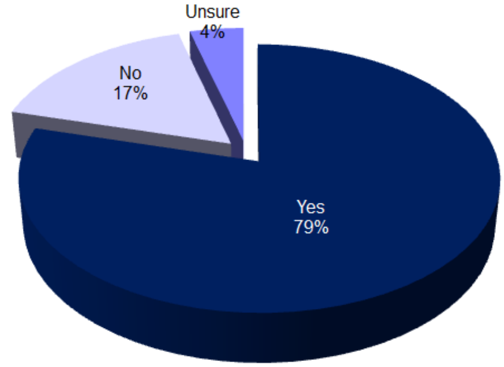
Source: TABB Group

European regulators now believe the link between turnover and payment for research must be severed. Only through complete unbundling of dealing commissions will firms reduce any wastage in the research purchasing process and uncover new cost-effective research sources to deliver value for money. Like all seismic changes, there will be considerable disruption to the current commission-based framework in the process: 67% of participants anticipate research commissions will decline (see Exhibit 1).

Smaller European brokers are likely to suffer. A decrease in consumed research will lead to a decline in investment in research provisions, which will lead to a fall in revenue, which will in turn make the provision of research an expense few can afford. Unattractive sectors may also suffer. We have already witnessed the widespread closure of small-cap execution desks. Few global investment banks will be motivated to carry out research on SME firms given the lack of profitability. If research is not produced, funds will also be less likely to invest. The contra argument is that this opens up the market to competition from more bespoke research providers and sector specialists facilitating a flight to quality.

On the buy side there is little doubt of the impact (see Exhibit 2). Larger buy side firms are widely perceived to have the ability to weather the storm, whereas smaller asset managers may not have the resources to pay for access to all the research previously available to them, nor can they fund this internally. In this competitive environment where few can afford to increase their fees, should market forces then dictate the outcome?

Exhibit 2
Will the proposed changes place smaller asset managers at a disadvantage?

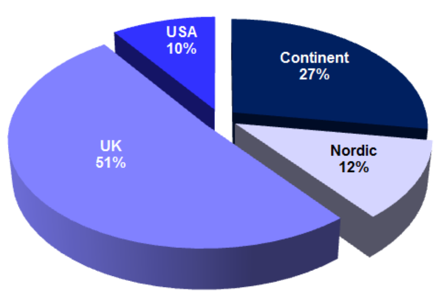


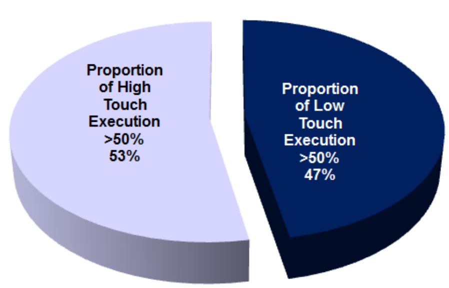
Source: TABB Group

It is not only about the research. Other important considerations remain. If research payments are unbundled from commissions the buy-side may have to foot a potential VAT bill, negating any potential savings from supposed misspent funds. Complex management of commission allocation payments to end funds will require in-depth technological solutions to solve new administrative headaches. Recent advances in the fintech space will undoubtedly provide some answers, but the level of disruption to the industry is yet to be determined.

With the asset management industry continuing to consolidate and operate on a global basis, these changes will resonate beyond Europe as firms adopt common systems globally to reduce business complexity. To investigate these issues TABB spoke with 51 asset managers trading European equities globally (see Exhibits 3 and 4) to establish how they propose to meet the new regulations.

Exhibits 3 and 4
Survey Participant Demographics – Location/Preferred Method of Execution





Source: TABB Group

CSAs – *Oui* or *Non*?

"We can only put in place what we know to be accurate. We are getting different messages from regulators and the now the politicians. The confusion is not helping us to unbundle"

Large UK Asset Manager

"While we are regulated by BAFIN and not the FCA, we have been watching what is happening: it is still a waiting game"

Large Continental Asset Manager

With European regulators at supposed loggerheads over the issue, the current debate between whether CSAs are admissible by the European regulator has left many in a state of confusion. Firms are stranded between systems in which they have already made significant investment, and the unknown. National sovereignty alone is insufficient for global firms; all regulators and legislation need to be considered.

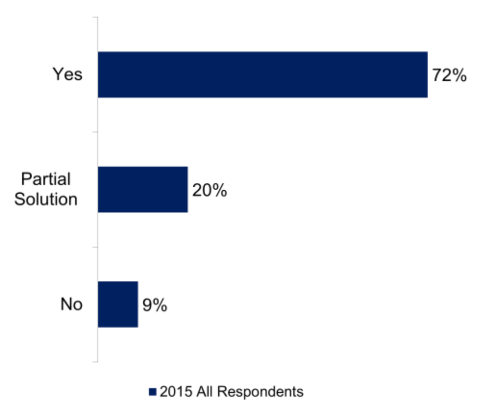
As of January 2017, investment managers will be required to improve their accountability over research payments. The traditional method of paying for research and execution through bundled commissions is no longer admissible:

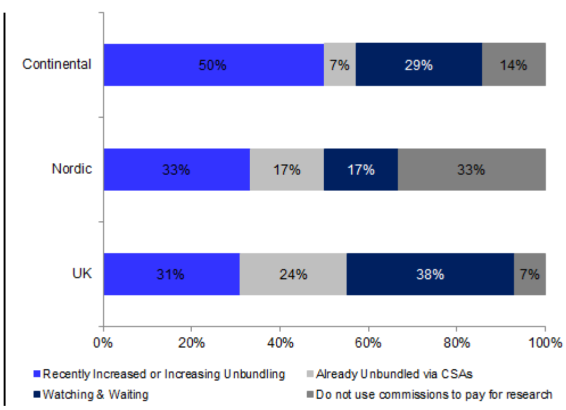
- Execution and research must now be paid for under separate arrangements.
- Research arrangements must have a pre-agreed budget, either
  - paid for directly or
  - via a ring-fenced research account funded by a specific charge.
- Budgets cannot be exceeded.
- Funds have to be repatriated where they are not spent.

The asset management industry is unequivocal in their belief that the mandated use of Commission Sharing Agreements (CSAs) offers the most pragmatic solution to the latest regulatory requirements, with nearly three-quarters in favour (see Exhibit 5). However, given the apparent regulatory disagreement between national regulators as to whether CSAs will be admissible, firms are halting unbundlingly of commissions until further clarity emerges later this year. Regulation is preferred by many for a consistent adoption across Europe but this does mean that member states lose some flexibility. The UK in particular has the highest proportion of firms in wait-and-see mode (38%); despite the FCA's recent firm stance on CSAs in its Feedback Statement DP 14/3 (see Exhibit 6).

Exhibits 5 and 6

Do you see mandated CSAs as a possible solution to the current regulatory deadlock? / Has the recent guidance by regulators impacted how you pay for research? (By Region)





Source: TABB Group

Unbundling Progress So Far

"We have been looking at budgets for the last four years; we know we have to do more. It's still a work in progress but each year we are refining the process."

–Medium sized Continental Asset Manager

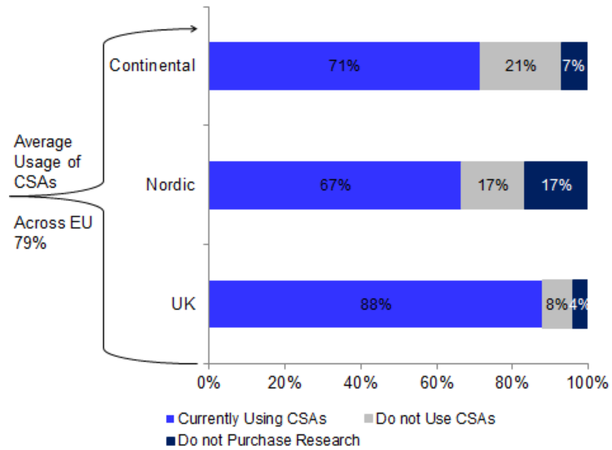
The FCA's view is that only total unbundling of research costs and execution commissions will enable firms to control costs, procure research in the best interests of their customers and improve competition in the market for research.

While industry participants may debate the FCA's views on full unbundling, many large global firms have been restructuring their commission payments over the last few years to an unbundled payment structure using the CSA framework.

UK firms have been at the forefront of unbundling commissions in Europe since the Myners report (2001) in which the FCA required firms to clearly identify what proportion of commissions were used for execution versus research. Some firms choose to formalize this process using CSA's, others simply by disclosure of their breakdown.

Under CSAs, a portion of the commission charged by the broker is segregated into a client account to pay for services used. A portion of the money in the CSA 'pot' may stay with the broker; the remainder is allocated to other brokers and third-party research houses. However, guidelines on best execution reinforced by MiFID I text failed to change mainstream behavior and the majority of European asset managers simply continued to bundle commissions together. This would now appear to be changing, with 79% of all participants now using CSAs, even in Continental Europe where uptake has historically been low (see Exhibit 7).

Exhibit 7
Current Usage of CSAs (by Region)



Source: TABB Group

"The FCA's Dear-CEO letter certainly focused the PMs and the allocation of commission dollars. We feel we have a robust commission management programme but we are looking into whether what we do is sufficient."

–Large UK Asset Manager

UK firms started reviewing their unbundling processes further because of updated FCA requirements in 2014. Asset managers are only permitted to spend their clients' dealing commissions on "substantive research" and the cost of executing trades. Payments for facilitating meetings with company managements (corporate access) were banned as failing to meet the new "substantive research" benchmark and so firms have needed to review their research payment practices.

All Eyes on ESMA

"If the ESMA proposal goes ahead, we will have to increase management fees on pension funds, but the commission fee structure is completely different to investment funds; if you are not entitled to pay for research - how do you distinguish between the two?

Large Continental Asset Manager

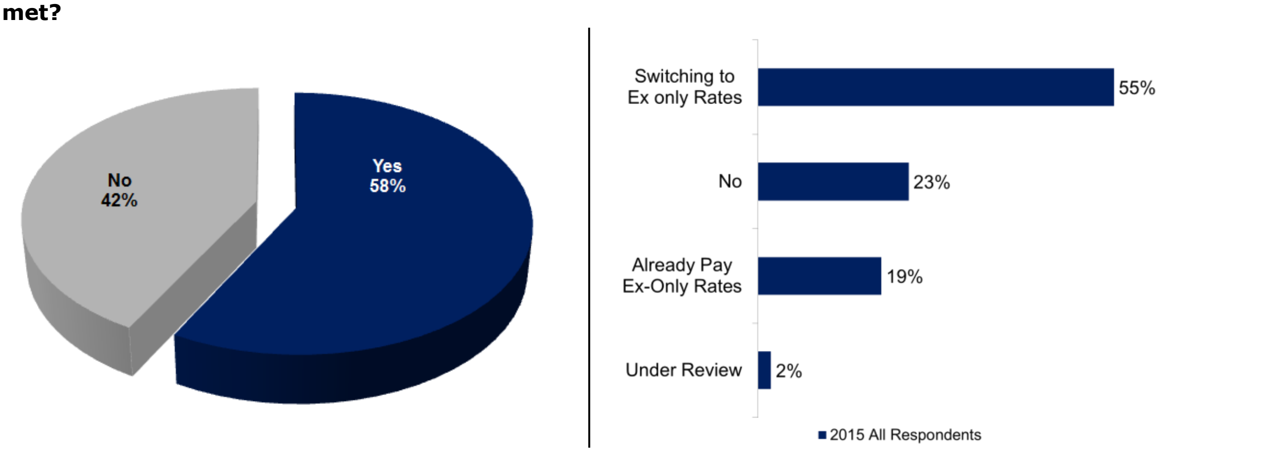
Under Recitals 74 and 75 of MiFID II, the European Securities Markets Authority (ESMA) is mandated to provide the European Commission with technical advice on the conditions under which research payments and non-monetary services can be provided and paid for. It is in the interpretation of the following proposed Level II text where the debate ensues:

> *The current use of CSAs by industry still enables* ***amounts charged for research by the investment firm to be determined by the volume of transactions of the investment firm with the executing broker****, although some investment firms apply budget to control the total amounts accrued in CSAs.*
>
> *ESMA proposes that the MiFID II Implementing measures should permit investment firms to accept third-party research only* ***where they pay for it directly or from a ring-fenced research account that is funded by a specific charge to their clients (subject to certain conditions, as detailed below).***

While this appears to be a fair and transparent process, if the commission charge is in bps, the question is whether ESMA will consider the remaining research allocation to be explicitly linked to turnover even if it is to meet pre-determined research budgets.

Many European asset managers do now have a system in place where they agree up-front on what they anticipate paying for research; the research budget (see Exhibit 8). Trading is then executed at full service rates with a pre-determined split in the commission going to pay for execution and research respectively. When the research budget requirement is reached, the commission rate is then reduced to execution only (see Exhibit 9).

Exhibits 8 and 9
Percentage of Firms with Research Budgets / Firms switching to Ex only rates when research budgets are met?



Source: TABB Group

"We have just increased our portion of commission to research payments from 60 to 70% but this now includes independent research. There is a continual re-evaluation of who we are using and why."

– Large Continental Asset Manager

Clearly, the progress any given firm have made depends on its starting point in terms of unbundling commissions, as well as the individual firm's understanding as to what "unbundling commissions" entails. For some firms commission targets have already been introduced and firms are working towards a fully unbundled model using a number of CSA partners. Others are still working to a matrix that includes a suite of commission scenarios—fully bundled, CSA and ex-only—depending on the underlying fund.

For those where the unbundling of commissions was limited to the introduction of a single CSA, firms are now beginning to establish processes to effectively budget and establish a value for research. Targets are established relative to the revenue of an individual fund or aggregated accounts across research teams at a strategy or group level. The challenges in establishing a research budget have been eased by the rise in the number of independent research providers who already price and invoice asset managers direct.

The budget process is clearly work in progress for many. Opponents state that budgets are set at such levels that there is little likelihood in reaching ex-only rates. However, those who have had a budget in place for several years commented on how annual refinements to the process have readjusted budgets to account for this; even increasing the overall amount paid. The real challenge is establishing the correct price to pay when the value of the research is often only known after the event, as well as how to distribute research costs across multiple fund participants.

"We no longer generate enough commission dollars to get access to research. We either have to arrange propriety research or conduct it on our own"

Small Continental Asset Manager

Many firms across Europe are introducing CSAs and budgets for the first time, particularly to pay small and mid-tier brokers where it is no longer efficient to pay them through commissions. Some smaller European funds had been forced to fully unbundle their commissions entirely through lack of coverage, particularly in relation to small cap stocks. Either the SME firms are no longer covered by the global investment banks or the asset management firms in question did not generate sufficient commission dollars to support a full service model. Their only recourse was now to access firms direct and pay for independent research to be written themselves.

"We are all aware of what you guys are doing, but this will <u>never</u> happen over here."

- Medium sized US Asset Manager

US firms interviewed split into two camps: those that do not pay for research using commissions and those that still do. In the US, funds have to report annually to the Department of Labor which of their counterparties were paid more than $5,000 and the fund has to value the research received. For the US funds that do still use client commissions to pay for research, the process behind the payment may be entirely unbundled, even down to execution-only commission rates. The client, however, is still charged a bundled fee and these firms believed that was unlikely to change any time soon, irrespective of change in Europe. Therefore, for the purposes of this research, geographic breakdown of participant responses has been limited to Continental, Nordic and UK participants only.

Wastage in the System

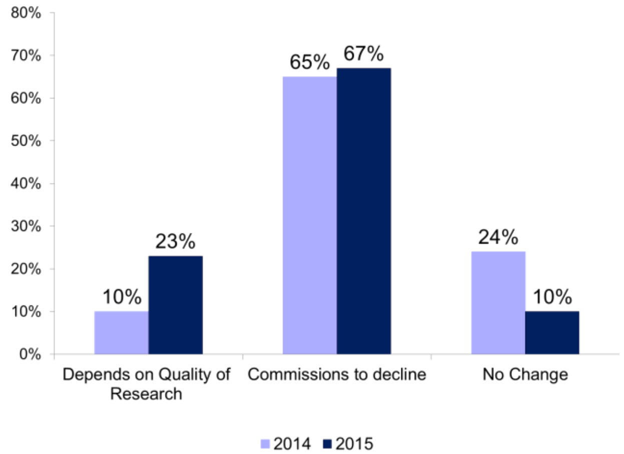
"I receive a 1,000 BBG messages a day; I read 5 or 10. This mismatch between the buy and sell side will disappear. There will be much clearer communication to brokers about what we want."

–Large Continental Asset Manager

The central argument of both the UK and European regulators is that there is considerable wastage in the system. The UK's FCA is of the opinion that, *"there is currently an over-supply of low value, duplicative research coverage of large corporates,"* which the dealing commission regime has reinforced to the detriment of high quality independent bespoke research.[1] In the FCA's opinion, the risk is that with research expenses "bundled" into commissions for executing trades, clients receive a deluge of research reports from brokers trying to grab a larger share of trading revenues for free.

There is little doubt that greater transparency of fees and costs will ensure that asset managers are charged only for what they consume and achieve better value for money for the end investor. What many question is whether we need to shift to complete unbundling in order to achieve this required level of transparency.

Exhibit 10
Impact of regulation on research payments (2014 vs 2015)



Source: TABB Group

Wider Industry Changes

The reality is that the industry is already undergoing seismic change in the provision of research.[2] In 2014, 65% of participants anticipated that research payments to bulge brackets would decline; this number increased slightly in 2015 to 67%. However there was a switch in participants who perceived there would be no change to research payments as a result of regulatory changes, to those who felt that the impact would be dependent on the quality of the research in question (see Exhibit 10).

"I can see people prepared to pay a significant premium for high quality research – but if it's not adding value, you shouldn't be paying for it. And the trick has been establishing the value"

–Large UK Asset Manager

[1] http://www.fca.org.uk/your-fca/documents/feedback-statements/fs15-01
[2] TABB Group, European Equity Trading 2014

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"We are trying to explain to the PMs the cost of what they receive. PM's don't realise how much they pay for that it is not actually related to the service that is received!"

- Medium-sized Continental Asset Manager

The increased use of technology and ease of Internet access is dramatically altering the design, price, distribution, and consumption of research; global investment banks no longer hold the monopoly.[3] Many brokerages have retrenched coverage, particularly in the small and mid-cap space, as research departments have been slashed through wider cost-cutting exercises. This has led to the increased use of niche research providers in Europe.

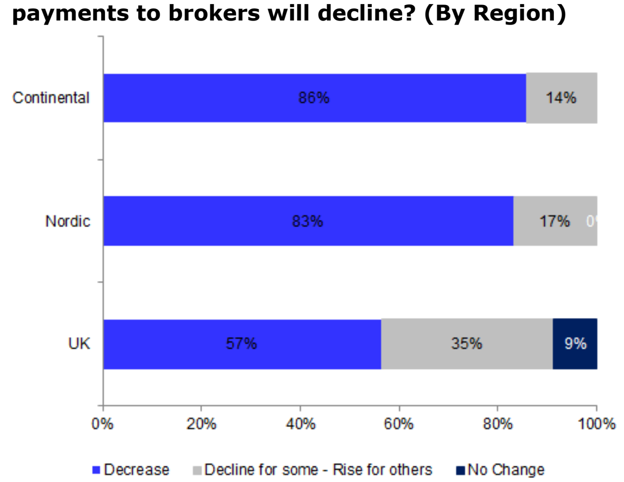
What is now rapidly changing is the ability to establish the value of research. New technological solutions are emerging to monitor current processes such as data mining consumption of research and capturing votes for unpriced research. In addition fintech developments now enable asset managers to assess and rank independent analysts from multiple firms. By being able to objectively measure and compare the real value of equity research, portfolio managers are now able to assess whether they still wish to receive the phone call, visit, or report from individual analysts at different brokerages.

"There is a challenge as firms won't be prepared to pay for research that is general and everyone has read but individual bespoke research – that's unique value and has to be paid for.

- Large UK Asset Manager

Clearer communication from clients to brokers over what is now required, versus what was previously provided for free, also improves the quality of research provided as brokers can better target what they provide to whom. The demand for waterfront coverage remains but the focus will be on quality rather than quantity from an increasingly tighter collection of niche core brokers. No portfolio manager has the revenue to justify paying multiple brokers for a redundant service. This was especially evident amongst the UK respondents, with 35% anticipating a greater flight to quality (see Exhibit 11).

Exhibit 11
What is the likelihood that your total research payments to brokers will decline? (By Region)



Source: TABB Group

[3] TABB Group, One Touch, One World: The Future of Investment Banking 2013

Increasing Management Fees

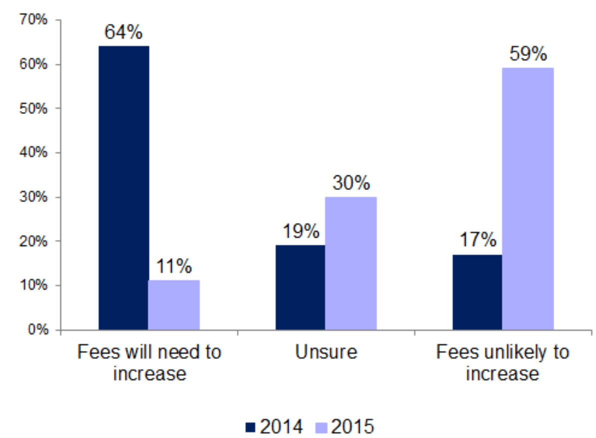
"The business model is no longer sustainable. Funds can try and absorb these costs but this will be harder for smaller funds. Then it's a question of market competition"

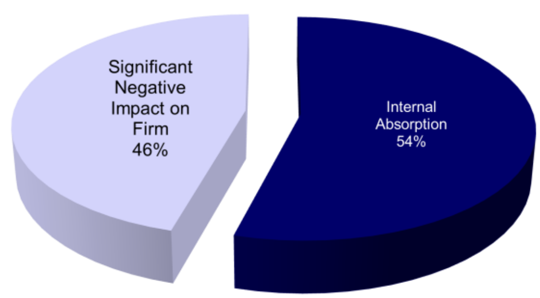
Medium-sized Nordic Asset Manager

In 2014, prior to the publication of ESMA's technical advice, 64% of participants anticipated that because of proposed regulatory changes firms would have to pay for research independently through management fees. However, the reality is that this will be difficult to achieve in the current competitive environment. End investors have little appetite for increased costs and as such 59% of participants now do not anticipate an increase in fees (see Exhibit 12).

Firms did acknowledge that there is perhaps a one-off opportunity for the industry to move in tandem, for management fees to increase by "x" basis points with trading fees (execution only) and any research will be paid for additionally from management fees. But the reality is that the industry is already fighting disappointing returns and a client base focused on the bottom line. The recent rise in passive index trackers, which charge much lower fees than active investment firms, highlight the challenges firms now face.

Exhibits 12 and 13
Impact on management fees (2014 vs 2015)/Impact on firms if management fees cannot increase to pay for research (2015)?





Source: TABB Group

In addition, for firms to fully unbundle commissions and pay for costs direct from their bottom line, there is a stark difference in opinion as to how viable this is for the firm in question. 46% of those who felt their firm would be unable to increase their management fees to pay for research believed that it would have a significant negative impact on their organisation (see Exhibit 13).

Even if the industry were able to achieve the imposition of an industry wide additional charge, there is then the potential for regulatory arbitrage. In the end, for firms to be able to weather the storm, it all comes back to a question of size.

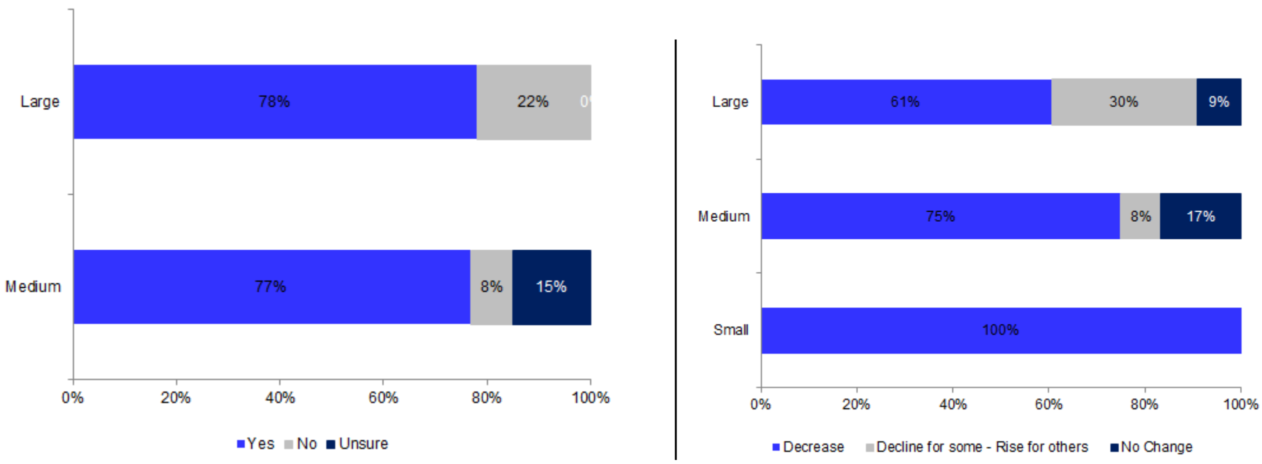
David vs Goliath

"How do start up's get off the ground unless you have a wealthy guy who can sign all the cheques? The economics just won't make sense"
Medium sized UK Asset Manager

The industry believes unequivocally that the loss of dealing commissions to pay for research will impact smaller asset managers rather than larger (Exhibit 14). While 100% of smaller asset managers saw themselves at a disadvantage, three-quarters of larger asset managers also perceived smaller firms would be negatively impacted. The sliding scale in declining research payments relative to a firm's AUM is indicative of the predicament smaller firms now find themselves in (see Exhibit 15).

Theoretically the research payment should be the same irrespective of the fund size and the number of trades. The issue is that if two funds want a piece of research, and that research is priced 50/50, the cost to smaller fund will be disproportionate to the amount paid by that of the larger fund. A large asset manager with billions to invest can monetize investment ideas far more easily than a firm with a total research budget of €1 million (if they have even that). This leaves firms with hard choices if they are unable to pay for research out of increased management fees.

Exhibits 14 and 15
Will smaller asset managers be at a disadvantage? (By AUM)/ Will total research payments to brokers decline? (By AUM)



Source: TABB Group

"If we had to cut cheques right from the bottom line, it would significantly impact the profitability of the firm and our ability to maintain headcount."
–Medium-sized US Asset Manager

As a result of their scale, larger client base and diversified range of investments; larger firms payments to research providers contribute significantly to the availability and pricing of broker research services across the industry. As such, some larger asset managers believe that they may have not only been subsidizing lower margin products internally in the past, but also lower margin products at other smaller firms – 22% did not see smaller asset managers at a disadvantage (see Exhibit 14).

However, funds with a global mandate have a broader pool to fish from in in order to seek returns, but global mandates also require greater investment in terms of research coverage. If research costs dictate that the fund is

"The business model is no longer sustainable. Funds can try and absorb these costs but this will be harder for smaller funds. Then it's a question of market competition"

Medium-sized Nordic Asset Manager

confined to UK large companies then the PM's options are much more limited. If the fund seeks to leverage alpha across different asset classes then the payment for research predicament is heightened still further.

Smaller firms will struggle to provide the breadth and depth of research as they can no longer rely on brokers for the provision of research nor leverage research payments across funds. This is evident when looking at the breakdown in decline of commission payments by AUM; small and mid-tier asset managers anticipate an overall decline, whereas larger firms anticipate a flight to quality.

There is an argument in favour of market forces—that the asset management industry is saturated and requires consolidation. Firms with higher costs and zero economies of scale cannot hope to compete with the large US funds, which increasingly dominate the market. Is this really the preferred option for the regulators?

The reality is that as with the sell side, the buy-side will need to go niche or consolidate to create the economies of scale to survive. Smaller boutique firms can manage the increased cost internally but only if their product range remains focused on a smaller number of products and sectors. The pool in which they are able to compete will shrink. Larger managers will need to continue to survive through mergers and focusing on economies of scale.

Growth of Independents

"Our use of independents is growing year on year – CSAs offer us the best of both worlds. The ability to trade with those who give us the best execution and research from the small boutique shops with the right alpha opportunities."

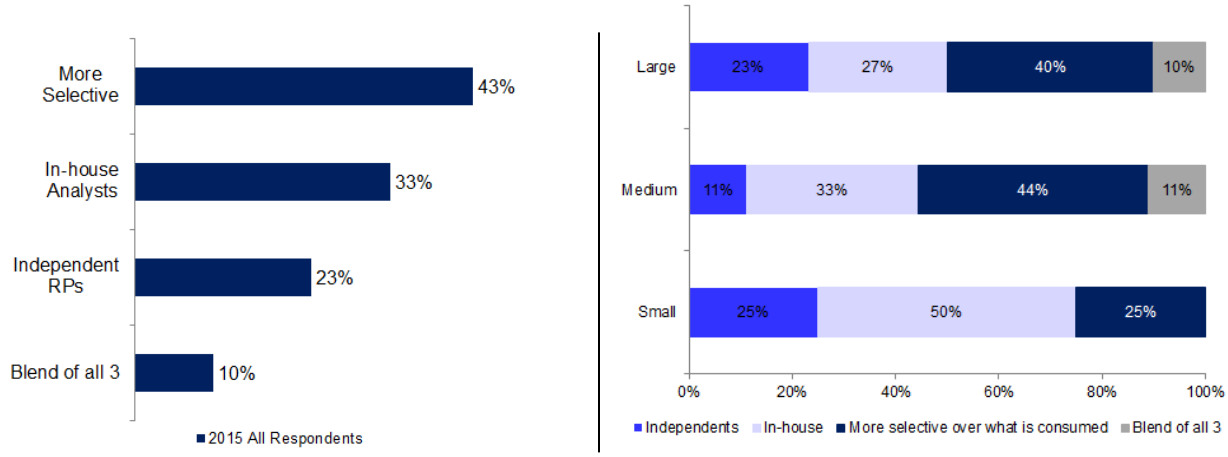
–Medium sized US Asset Manager

The search for improved alpha has contributed to a steady increase in the use of bespoke independent research as an alternative to standard valuation models. It is no longer just hedge funds that choose to invest their research dollars in initiatives such as ground surveillance on the progress of mining or oil projects in Africa. With low bond yields set to continue, managers will intensify the search for alpha in order to generate sufficient returns to meet their liabilities.

The FCA's argument is that by reducing payments made on duplicative research *"investment managers would purchase more value-added, in-depth research on smaller companies and niche sectors to better inform investment ideas for their clients."* This is already occurring through increased use of CSAs. However, there is no guarantee that firms will be able to switch from a planned payment through a CSA to a hard-dollar payment up-front.

The FCA acknowledges the industry's concern that some firms will be unable either to absorb the cost of external research or to pass it on in higher annual charges. This would potentially reduce their spending on third-party research, leading to poorer investment decisions. This was verified in conversations with participants: 43% anticipated an overall decline in research consumption through more selective consumption, rather than an increase in independent or in-house research (see Exhibit 16).

Exhibits 16 and 17
Future Research Consumption (All Participants and By AUM)



Source: TABB Group

"As a small fund, I suspect we will have to manage internally. It's good to have broker research to verify our decisions but we can't afford to pay this direct."

–Small UK Hedge Fund

Smaller asset managers in particular anticipated a greater shift to in-house analyst teams (see Exhibit 17) but there is a limit as to how much can be achieved without achieving independent third party verification. Boutique asset managers can retrench to a smaller portfolio of assets in terms of both geography and sector. Medium size firms looking to compete with larger asset managers will struggle. One participant commented this was also likely to impact SME research coverage. Without research being written, asset managers are unable to invest; consequently, SMEs may face a decline in their ability to raise capital and increased illiquidity.

Administrative Headaches

While higher margin businesses can absorb the hit of increased management fees to pay for necessary research. Lower margin businesses that cannot, will go to the wall. The economies of scale that will enable larger asset managers to absorb costs internally are not limited to just the cost of research.

"A firm of our size just simply does not have the finances or the technology to manage this level of administration."

–Small UK Asset Manager

If individual client accounts must now be charged specifically for research consumed, this will introduce a new level of operational complexity. There is the logistical maze to work through to estabish which client should be charged for what, and firms will need to consider their client-money position if payments can only be made from a specific ring-fenced research account. These accounts must also include robust governance and disclosure requirements; firms will need to regularly review their third-party research requirements and the quality of product received.

Appropriate management oversight must also cover clearly defined budget allocations, which will need to be agreed on in advance with clients. These

"Without cross-subsidisation not only our research costs will have to go up, we will have to invest in budgeting tools, research, execution - it will be massively onerous"

UK Medium sized Asset Manager

"We all know it's about being a smarter consumer, but if you keep squeezing these firms, they will go under. It's simple math; regulation costs firms and costs jobs".

Medium sized US Asset Manager

may not be exceeded without written agreement; another factor to be monitored and controlled.

While research budgets can be adjusted up or downwards to ensure the correct fee is charged for the correct intake of research, the administrative headache to manage this if clients have to pay for research direct "ex ante" (ie based on the expected return of an investment portfolio) is not insignificant. To limit unnecessary costs research should ideally only be paid for if it is considered to be of use, and establishing what should be paid for research before it is clear whether any value has been derived is complex.

Consolidated portfolios will clearly find this process easier to manage. The larger the group of funds, the greater the level of complexity, but smaller firms who currently "share" research between funds may also have an administrative nightmare on their hands.

Unbundling execution costs from research payments benefits the buy-side trader. Great research ideas only translate into fund performance once the trade is executed. Dealing desks with autonomy over when and where they can trade can focus on delivering best execution and improving short-term fund performance. Despite the regulators frustration with progress made so far, the challenge for the buy-side dealing desk is not to unbundle but rather how to unbundle within the proposed guidelines, and with declining resources, so that asset managers can still maintain their ability to pay for research in the investment process.

There will undoubtedly be new disruptors entering the market to plug the gap vacated by the investment banks but this will take time for the industry to adapt and change. For every buy-side firm, success or failure will now depend on their technology capability rather than just the size of their AUM, representing yet another blow for an already struggling industry.

The Big Squeeze

"The Sell side still equates the cost of research to their headcount, but the buy side does not equate this to the value of research they receive."

Large Continental Asset Manager

"Some brokers are prone to old habits and have really dragged their feet – others are choosing to lead the way"

Large UK Asset Manager

As buy-side firms scrutinise what they are paying for, there will be a continued decline in the overall services consumed from global investment banks and a more selective consumption of the services offered.

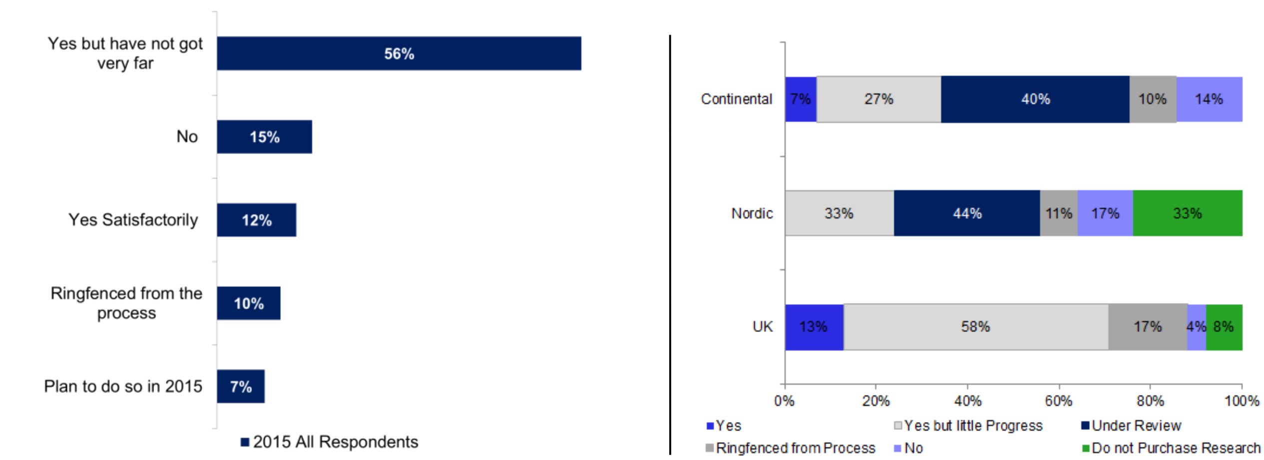
Unbundling may yet prove to be an opportunity for smaller brokers to focus on providing research tailored to clients underlying portfolios or SMEs looking to raise capital. However, in the interim traditional total research payments will in the main decline as asset managers continue to shrink their number of core brokers to focus on maximizing commission dollars to their best effect.

However, slow progress continues to frustrate the buy-side. Participants noted reluctance from certain investment banks to engage in discussions over the cost of research, with only 12% satisfied with the results of those discussions (see Exhibit 18).

UK participants had made the greatest progress on conversations, undoubtedly due to increased regulatory pressure, but they were also highest in terms of lack of progress made (see Exhibit 19). Sell-side brokers now need to provide prices to enable the buy-side to assess costs relative to the services they consume. Transparency is essential but all clients need to be provided with the information from all brokers in order for the industry to be able to assess the true cost of research.

Exhibits 18 and 19

Are you having conversations with your brokers about the cost of research (All Participants /By Region)



Source: TABB Group

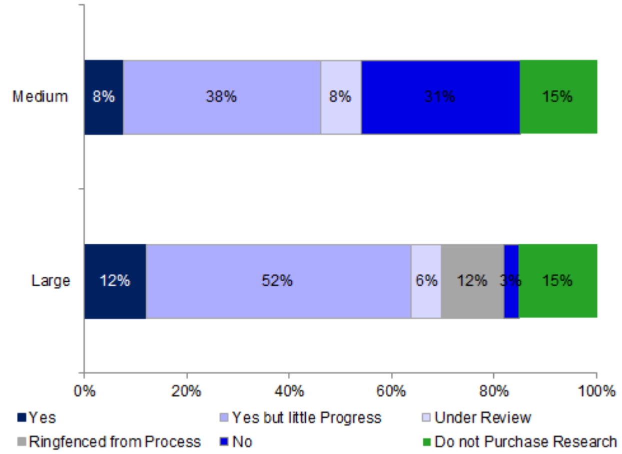
Nordic and Continental asset managers were highest in discussions with brokers being under current review. Increasingly buy side desks in the UK are becoming ring-fenced from the cost of research process underlining firms' desire to demonstrate the break between research and execution.

"We used the FCA as a big stick to get the answers we have been looking for, for a number of years. I don't think we would have been able to get the answers we needed without the FCA pushing brokers to come to the table."

Large UK Asset Manager

All small asset managers who responded indicated that they were now having discussions with their brokers regarding the cost of research but that little progress had been made. The majority of both large and medium asset managers were also raising the cost of research with their brokers, although 31% of medium sized asset managers had not yet begun discussions (see Exhibit 20).

Exhibit 20
Are you now having conversations with your brokers about the cost of research? (By AUM)



Source: TABB Group

The Price of Research

Few would perceive the current CSA structure as perfect. There are a number of incidents where the correct payments and balances fail to be correctly accrued. For example, a small cap broker executing a large small cap trade may receive a higher commission relative to the actual value of the advice. However, the challenge is how to replace this system which currently appears as the best alternative to "opaque" research model to date.

The industry has been deep in discussion regarding the intangibles of valuing research. If a portfolio manager purchases research on a small cap that has a "hold" recommendation how can the research be paid for unless it is straight from the bottom line? With an upside or downside cap on a single piece of research, can this now be considered an inducement to trade? There are more questions than answers and as such, accurately pricing of the cost of research has continued to bedevil the industry. Yet it is no longer enough to claim the other counterparty needs to determine the true cost. The regulatory onus may remain on the buy side to provide this but the buy side now has to start demanding the sell side provide sufficient pricing points in order to move the process forward.

"This is where the brokers are getting it wrong - if you think your senior people are good then you should be confident that people will pay a significant premium for this"

Medium sized UK Asset Manager

Once this is provided, two challenges remain. Firstly the potential disagreement as to the price provided. The sell side may equate the cost of the services consumed to headcount; while the buy side may not necessarily equate the same cost to the research value they receive.

Secondly, the transparency has to be across all firms and all clients in order for the industry to be able to assess the true cost and value of the research.

Participants were very vocal in the lack of input they believed they were currently receiving from certain brokers. Others were highlighted for the pro-active approach they were choosing to take – Credit Suisse, Morgan Stanley and UBS were all singled out as making a concerted effort to rollout a model to price for research.

There are various options currently being proposed:

- by sector
- “pay as you go”
- And single-priced “advisory services” where the single fee would include research calls and access to corporates calculated on an average of commission payments from previous years. Again, the advisory services based on a single client’s usage has to take into account not only the client’s payments but relevant peer’s payments in order to establish a true market value.

As the industry starts to engage in open debate, pricing structures will refine and improve. What is clear is that it is no longer enough to stand on the other side of the pitch to blame the opposing team without incuring the wrath of the regulators. The industry needs to increase the level of transparency around costs and fees, and do so as a matter of urgency.

The Swedish Solution

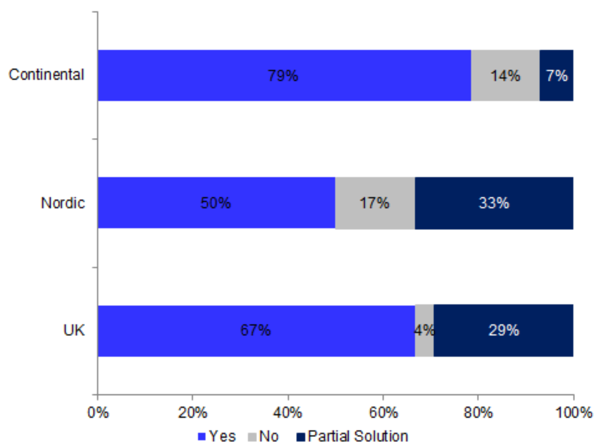
"If a client joins in September what happens if the research payments were completed by Q1? Is this fair on other participants in the fund?"

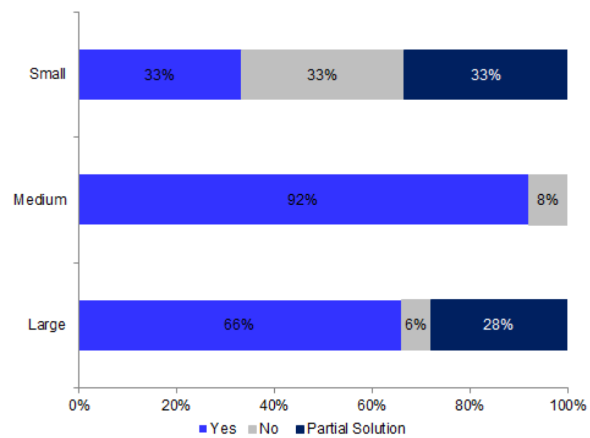
–Large UK Asset Manager

Among the current regime one concern of moving to ex-only commissions once research targets have been met is how firms can account for a fair allocation of research payments across multiple clients. It is difficult to envisage how clients who join a fund after the research decision has been taken can contribute fairly to the cost of that research if the buy side firm has already moved to ex-only commissions, without the individual research budget for a new client being prorated accordingly. If a firm uses a blended approach to the commission structure, there can be different treatments for different clients. If these clients are then looked after by different teams, one team may generate more trading (and therefore research credits), from which another team may benefit in terms of research consumption. Alternative trading strategies generate a variety of trading commissions, which leads to unequal allocation of costs between clients.

It is these conflicts which are leading some asset managers to suggest that the preferred solution will be one proposed in a number of Nordic countries, where firms have moved to a fixed-base commission model for execution, together with an additional daily charge per fund to pay for research direct. For funds which have one main client (such as a government pension fund, for example) it is easy to establish the benefit of a daily charge, but for those with multiple funds it merely accentuates the administrative headaches discussed previously. Even so, even 50% of Nordic responses indicated that mandatory CSAs would be the best regulatory solution currently (see Exhibit 21).

Exhibits 21 and 22
Do you see mandated CSAs as the best solution to the regulatory deadlock (By Region/By AUM)





Source: TABB Group

"If regulators opt for the mandated CSA plus model, we are virtually there. If they go for the Swedish model I simply have no idea how we could implement this."

Large UK Asset Manager

Medium-sized asset management firms however overwhelmingly were in favour of mandatory CSAs to manage commission payments. While nearly all market participants acknowledged the administrative difficulties in managing a complicated CSA process; this was considered no different from the administrative burden of segregated mandates. The Swedish model works if the firm has one or two funds and ten brokers to pay; then the administrative burden would be manageable. To change that to hundreds of clients across multiple accounts and a hundred plus brokers and it is arduous in the extreme. Similarly, pre-agreed research budgets arranged with each individual investor has the potential to be complex to manage. What if some clients agree and some do not? Participants acknowledged this issue but stated that if it were communicated in an annual letter rather than via a change in the terms and conditions, it could limit the increased administration.

"We will continue to use full service commissions for now but with a full breakdown. We are becoming more scientific about our approach rather than viewing research as higher rating de-facto. We will still attach research portion then go to ex only when it is no longer required, breaking the link between research and execution through the budgeting process."

Large UK Asset Manager

A more feasible approach may be to use the CSA as a budgeting and payment mechanism. Firms pay execution fees on a trade-by-trade basis and make a regular payment for research on a pre-determined basis—daily, weekly, or monthly—into a pot where research fees are pooled separately and then charged according to which services the underlying fund has received.

Using dealing commissions but with budgets and clearly defined payment mechanisms will provide the required enhanced transparency but prevent subjecting smaller firms to financially onerous one-off hard-dollar payments or administrative burdens that would be overly complex to manage. The number of potential conflicts reinforces the view that there is unlikely to be a one-size-fits-all solution that will be adequate.

Progress in greater transparency over research payments is being made, but there is still much further to go. Some participants are using the traditional broker review to generate a scorecard, which they share with brokers in order to frame how analysts and research services are received. Other brokers have put together menu pricing, but without a standardized framework it remains overtly challenging for asset managers to compare broker against broker. The variety of matrices and models are leading some to suggest that there should be an industry standard similar to Fix Protocol standards on algorithms and now IPOs.

Onto Execution

"Execution is fast becoming a strata of services rather than just high or low touch rates"

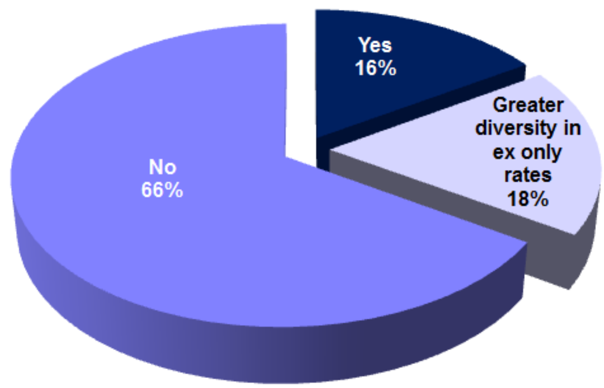
Large Continental Asset Manager

"Commoditised access to algos will continue to fall, but in its place we will need menu pricing - for higher value services, capital commitment, cross subsidisation etc, almost on a trade by trade basis. How do our systems cope with this? "

Medium sized UK Asset Manager

While the overriding message is that execution-only commission rates will not increase as a result of the removal of any research costs (see Exhibit 23), the reality is that a greater diversity in execution rates is now required. As liquidity continues to challenge traditional execution methods, all commission rates will not continue on the downward spiral of late. Rather, the overall cost of execution will be scrutinised in the same manner as research payments, with bespoke rather than blended rates being introduced.

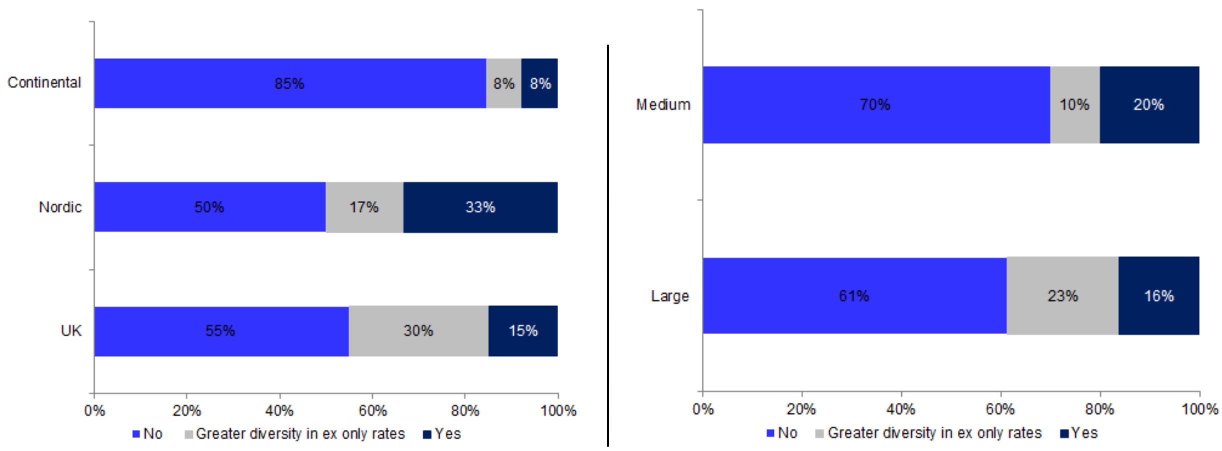
Exhibit 23
If research payments to brokers are in decline, will execution only commissions have to increase?



Source: TABB Group

Commoditised access to algorithms will mean standard low-touch commission rates are likely to continue to decline, but in their place a requirement for execution-menu pricing is emerging, depending on the service being provided. Whether the broker is providing quality block liquidity, access to capital (particularly when trading small and mid cap names), or enhanced infrastructure and bespoke algorithmic strategies, buy side firms acknowledged their willingness to pay for quality brokerage services where they were provided, irrespective of whether this was research or execution. Again this was more prevalent in UK firms who historically have had a more varied range of commission rates (see Exhibit 24) and larger firms who have a wider range of orders to execute (see Exhibit 25). In contrast all smaller asset managers who responded did not anticipate an increase in execution rates.

Exhibits 24 and 25
Will Execution Only Commissions Increase (By Region / By AUM)



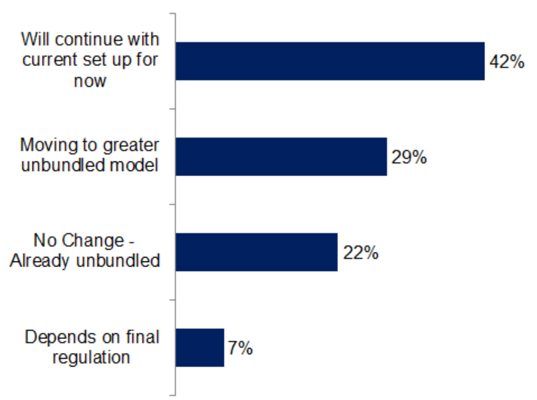
Source: TABB Group

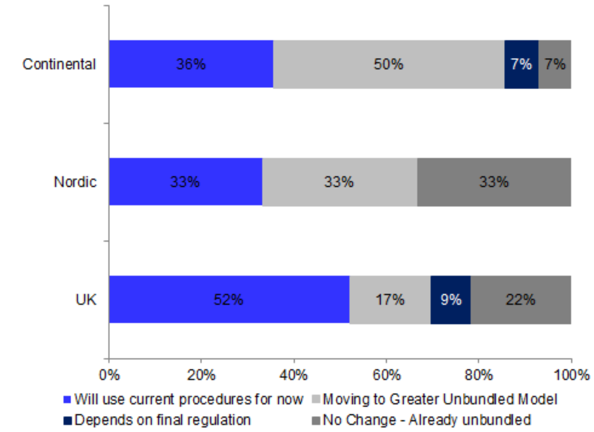
A number of participants also acknowledged the need for commission rates to start factoring in the clearing costs, considering the overall cost of execution rather than just the front -office point-of-execution cost, which will require greater transparency over the full cost of the trade. Recent announcements by the regulator reinforce the requirement for full transparency over all costs which again puts the onus on firms' use of technology. The ability to recognise individual trades and apply multiple versions of potential commission rates, communicating correct nominal amounts to counterparties and end clients will require ever more complex "rules" engines to automate execution processes.

Full Brokerage for now

The majority of participants anticipated they would continue with full brokerage commissions in the immediate term (see Exhibit 26), working towards increased unbundling over time and using budgets to break the link between research and execution.

Exhibits 26 and 27
Will you continue to use fully bundled commissions? (All Participants/ By Region)





Source: TABB Group

"As soon as we get the regulatory clarity we need, you are going to see an overnight shift; all those who have been sitting on the sidelines, once they know CSAs are the way forward they will make the jump"

Medium sized Continental Asset Manager

The largest proportion of respondents who plan to continue using current unbundling procedures for now were those based in the UK (see Exhibit 27). This is a result of the level of the unbundling that has already occurred as well as the regulatory confusion regarding CSAs. Continentals are those most likely to move to a greater unbundled model, but they too are waiting for regulatory clarity, with firms talking of CSA agreements sitting on desks in front of them waiting to be dispatched as soon as they are given the go ahead.

Once regulatory clarity is provided, firms indicated unbundling will continue in earnest to ensure that firms get to the level of transparency required by 2017. If CSAs are still admissible, the administrative headaches will not all be resolved. Best execution obligations are likely to result in CSA agreements

"We do feel that we were already operating under best practice rules - it just seems like this is generating a whole lot more paperwork - this is just all common sense."

Large UK Asset Manager

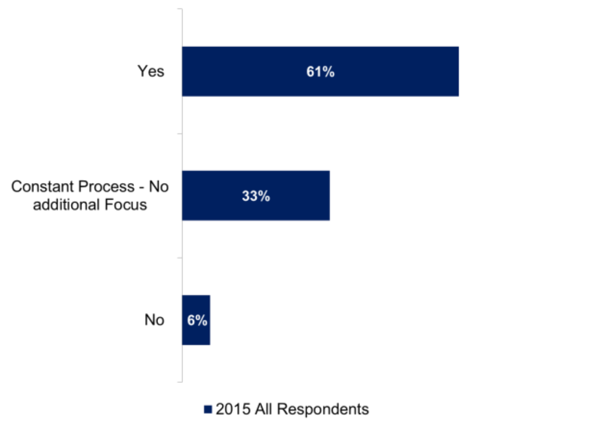
for each counterparty, creating further administrative complexity. The argument being that if some brokers are CSA and some are fully bundled, would firms would be more likely to give the order to a CSA broker when they have research bills to pay.

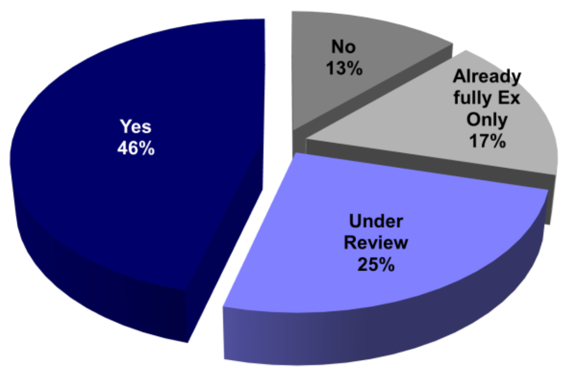
In fact, what is more likely to happen is that counterparty lists will continue to shrink. As asset managers' grapple with best execution requirements under MiFID II, order flow is likely to move back into the hands of a few liquidity powerhouses. Once more, the global investment houses look likely to benefit at the expense of smaller mid-tier firms.

Back to Best Ex

The provision of best execution will require breaking the link between turnover and research. Price discovery tends to be positive for high-quality producers of research, but is extremely commoditising for generic content from global investment banks. Breaking the monopoly encourages competition and a reallocation of spend among research providers, all of which is beneficial for the end investor.

Exhibits 28 and 29
Are you reviewing internal processes/current broker relationships as a result of the FCA's Thematic Review of Best Execution?/ Do you anticipate moving to an execution only model?





Source: TABB Group

Although firms across Europe are turning their attention to internal processes around best execution, a third commented that this is continual work in progress and not a specific response to regulators attentions (see Exhibit 28). While some continental participants claimed that they would be unlikely to implement any significant changes to implementing Best Execution policies unless they were mandated to do so, others are now making this a priority. However many commented that Best Execution must been seen in terms of the overall picture rather than one single trade.

It is doubtful whether end investors care whether research is paid from commissions or hard dollars, what is of greater concern is the lack of clarity and accountability for how funds account for what is purchased and why. Demands for greater transparency over costs and fees will only increase. As such firms perceived it was only a matter of time before execution only commissions will become the industry standard (see Exhibit 29).

Local to Global

"Concerns over extra-territoriality are overplayed. These changes represent inevitable industry change."

–Large Continental European Asset Manager

"You would hope that this becomes part of a larger conversation with IOSCO."

–Large UK Asset Manager

"We are already getting calls from clients outside Europe asking how we evaluate research and what tools we use to monitor research payments. It's clear we will have to adapt this…for all our mandates globally."

–Large UK Asset Manager

Many participants voiced their concern regarding the potential for regulatory arbitrage if the UK is forced to fully unbundle commissions in isolation. The FCA's view is that this is unlikely to happen. As global active managers seek to act in the best interest of their customers, higher international standards will be required and, as a result, feasible commercial models will ultimately emerge.

The FCA reiterated that it does not plan to change the rules unilaterally and is keen to engage in the European debate to ensure a level playing field across Europe. Their preference is to maintain UK rule structure *"through or alongside implementation of MiFID II reforms"*[5]. However, the UK regulator acknowledges that it, *"will need to review (its) approach once the final details of the legislation are confirmed,"* including interactions with existing requirements such as AIFM and UCITS investment advice.

The European Commission will not make its decision until later this year and even then this needs to be approved by the European Parliament and the European Council. Even if the European Commission permits enhanced CSAs as well as direct research payments, the FCA does not have to follow suit. Therefore the possibility of regulatory arbitrage between UK and European asset management firms remains. However, if large European asset managers have to implement one system in order to meet the FCA's requirement for research-payments direct, some have indicated that they have to take the fully unbundled route rather than operate two separate payment mechanisms.

The challenge with the current proposals is that if a fund is domiciled in the European region but holds stocks traded and researched in a separate region (e.g. US and Asia) then the need to price research not only impacts European brokers. All brokers who want to provide research to European firms must also price their research.

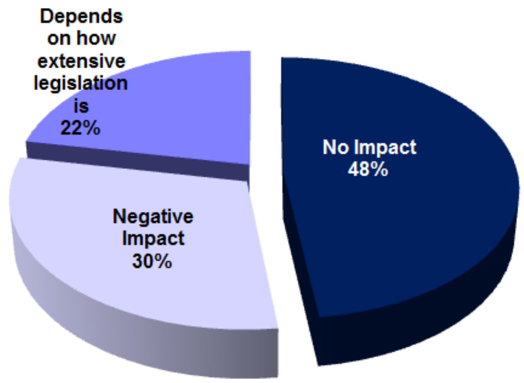
The FCA agrees that cooperation and coordination between regulators is a necessity. Aspects of this are already under discussion in IOSCO, so while there might be derision amongst those on Wall Street, with the asset management industry continuing to consolidate and operate on a global basis, the proposed changes are likely to resonate on a wider scale as firms choose to adopt common global systems to reduce complexity for their businesses.

"It has been suggested internally that we should relocate back to the US."

–Medium-sized UK Asset Manager

Participants agreed that it would be preferable to establish a global commercial solution to pay for research rather than a local political one in order to limit further market upheaval. However, just under half of the participants felt the interest to invest in Europe currently is sufficiently robust not to materially impact investor appetite at this stage (see Exhibit 30). There was disagreement amongst participants as to the level of impact, with a third believing the impact would be a negative and one participant indicating there may be a requirement to relocate.

Exhibit 30
Will the current proposals have a negative effect on investments in Europe?



Source: TABB Group

Given the shift in greater transparency over fees and costs and the increased fiduciary responsibilities of trustees, it is unlikely global firms with global mandates will simply move their existing funds to regions that will still permit the use of dealing commissions, although it will be interesting to see where new funds are set up from in the future.

However, what is more challenging in the immediate term is how commissions will be managed internally for firms that choose to aggregate order flow to benefit from efficiencies of scale between alternate jurisdictions.

"If you have a global fund mandate, where is the incentive to set this up in the UK now?"

–Large UK Asset Manager

If orders generated in the UK on behalf of UK clients to buy US shares are aggregated with orders made on behalf of US clients by a US affiliate of the UK manager, both sets of clients can currently be treated equally by aggregating the order into a single trade. If the US affiliate directs the order to a US broker to avoid paying the additional research charge, this is no longer the case. There a risk that only one set of clients will bear the research cost. Alternatively, the UK asset manager may choose not to receive research and will deal at execution only rates, benefiting from the US affiliate continuing to receive the broker research for "free." Without the SEC changing their mandate, the potential risk for regulatory arbitrage, however slight, remains.

US Jurisdictional Challenges.

"The US will never unbundle. We have seen large global institutions take the decision unilaterally but the SEC has no interest to mandate this. It's never going to happen here."

–Medium-sized US Asset Manager

The global nature of fund management means that not only do firms have issues of regulatory arbitrage to consider, but also issues of regulatory confusion.

The belief is that in the United States, the dealing commission process currently operates under a system of transparency, by obligating funds to report annually on which of their counterparties were paid more than $5,000 and what the value the research received was. As well as the legal obligation, investors have the option to follow up with requests for further information should they wish to do so.

Research analysts are not considered advisors under US Investment Advisor law. The SEC has provided limited no-action relief in this area[4] and most major US brokers do not generally accept cash payments for research. Even if US brokers were willing to accept cash payments and submit to investment advisor regulation over their research, US laws governing investment advisors would result in these brokers limiting their transactions with European portfolio managers and their clients to agency transactions only. This potentially could mean that European portfolio managers and their clients will be disadvantaged because US brokers may refuse to provide them with bespoke or other value-added research. Even if European portfolio managers move to execution-only services, they could also be impacted by limited principal services as the execution-only commission rate comes under further scrutiny.

If the EU were to change the way dealing commissions operate as proposed in the Technical Advice, some argue that the dual nature of the compliance regimes would have a potential negative effect on the quality of research available; impacting smaller and medium-sized research firms and investors in particular as a result. The reality is there will undoubtedly be a negative impact. The question is how long this will last; and whether the regulator believes this is a price worth paying to deliver greater transparency for the end investor?

[4] http://www.sec.gov/rules/interp/34-45194.htm

Fixing Fixed Income Research

"It's worth having credit analysts in house to crunch data to come up with good ideas, but it's an expensive business hiring an army of analysts."

Medium-sized UK Asset Manager

The restriction on inducements under MiFID II will apply to all asset classes. As with equities, the regulator intends to improve the clarity of transaction costs. In fixed income, costs of research currently are mainly embedded within the negotiable bid/offer spreads quoted by brokers.

Fixed Income is notoriously closed and the regulators' view is that by making these costs transparent, the market for providing research on the credit markets will open up to new independent providers rather than only the brokers in the bond markets.

However, if the leap from bundled to unbundled commissions is large for equities, then for fixed income, commodity and currency markets, it is gigantic. Paying for research is an entirely new concept. Trading is largely principal-based, with the bank taking on risk for managing the deal, which is factored into the spread, which pays for the trade.

"What is the fair price of research for something that hasn't traded in the last six months? How do you price options research, and how do we pay this; from futures commissions? I am at a loss to understand how this will work."

–Large Continental Asset Manager

If research is currently a material part of a broker's costs, the regulators view is that decoupling research from execution should lead to a narrowing of spreads. Unfortunately, there is absolutely no guarantee that this will be the outcome. The lack of liquidity already seen in the fixed-income market as a result of inventories being hit by Basel III capital requirements will continue to make trading more, not less, expensive. In addition, unbundling research from trading will further cut profitability for the banks, decreasing their appetite for risk and increasing the cost of trading further still.

Some participants are already paying hard-dollar commissions for third-party macro research, such as S&P, Moody's and Fitch bond ratings. This information, paid for by issuers, is already widely used by the industry. The challenge for new providers of research is the ability to evaluate the cost of research for a product that has not traded over the last year. As always, the true value is only what another individual is prepared to pay. Here, advancements in technology may once again assist.

What Lies Ahead

The changes in the distribution of research are already occurring irrespective of how firms choose to pay for this. Regulation is merely fast-forwarding natural evolution.

Critics argue that the proposed regulatory changes will likely lead brokers to focus only on larger companies, creating a dearth of research and corporate-access coverage for small and mid-cap firms. This will not necessarily be true for all. New tech start-ups are already creating online platforms for institutional investors that provide ranked equity research from a suite of independent analysts. These ensure that only the research of most value is produced, by linking analyst with investor as easily as you choose a holiday using Trip Advisor.

Previously the issue for the buy side in moving from a global broker one-stop-shop relationship to more bespoke services from multiple providers was the ability to locate the right product at the right time. The advance of the Internet has disrupted the proprietary nature of investment banking. Barriers have broken down and firms can drill through the online noise to access preferred analysts as they are required.

Fintechs are not looking at the provision of research only. Other brokerage services that have traditionally been the sole domain of the investment banks are starting to emerge from new independent specialist providers. For example, online platforms connect investors directly to corporates, negating the requirement for an intermediary broker to schedule meetings or roadshows. Online alternative finance, including equity-based crowdfunding and peer-to-peer business lending, grew 144% in 2014 and could hit €7bn this year[5] as mainstream banks curb lending and manage higher capital requirements and investors hunt for yield in an environment of record low interest rates.

Asset managers themselves will also come under scrutiny as a result of development of alternative distribution channels for retail clients, such as those providing more real-time interaction via smart phones. In a similar manner to airlines issuing tickets via QR codes, asset managers will have to develop technology to offer products and services in a more user-friendly format, with asset allocation, portfolio construction, and stock selection all online.

[5] http://www.jbs.cam.ac.uk/media/2015/european-alternative-finance-market-could-top-e7b-in-2015/

The traditional model between broker, buy side and end investor will continue to undergo complete metamorphosis. Even pension funds themselves are changing tack, moving to become direct lenders as deleveraging by the banks creates a vacuum for longer-term finance. Standard & Poor's estimates €2.7tn of debt will need to be refinanced by midsized companies between now and 2018, ensuring that demand for private placements in Europe is set to soar as companies look for funding away from traditional bank loans and are unable to meet the requirements for the traditional listed bond market.

None of this will happen overnight. The day of the intermediary broker is not done yet. Even in looking at merely the provision of research, the transition will not be without its challenges. As analysts charge and firms choose to compensate based solely on performance, fees will continue to decline as firms scrutinise costs and focus scant resources on where they can generate the most value. This will continue to drag prices down for the majority but also potentially create a "premier league" of top performers who will start to behave like football superstars demanding the earth. Are we sure then that the creation of niche specialist analysts will benefit all? What will come next, a secondary market for research? Anything is possible.

Conclusion

The regulators' aim is to ensure firms' better align their incentives to control costs and procure research in the best interests of their customers, improving competition in the market for research in the process. Few on the buy side would disagree with the objective. As European equities trading continues to undergo radical transformation, does the industry need a nuclear option to address the pitifully slow transition to greater transparency for end investors? Or will the perceived decline of research payments result in the masses restricted to dumbed down index trackers as the low cost Wal-mart pension option for the majority.

Unfortunately, like many other aspects of financial services regulation, the regulators perceive that the industry only has itself to blame. Delays to the introduction of greater transparency and clarity around research payments have left the regulators little choice but to act.

Recent campaigns such as True & Fair and Candid Financial Advice register the frustration of the man on the street with the asset management industry. New research purports that more than a third of the UK active fund industry is merely an expensive index tracker. Greater transparency and clarity around fees and costs must be provided as a matter of urgency.

Greater transparency is one side of the debate. Eliminating the ability for firms to compete is the other. The provision of research is already undergoing subtle shifts, which like a snowball have the potential to turn into an avalanche. As sell side start to cut clients off from access to research, difficult decisions will become more commonplace. If research providers are ranked in the Top 5, but are only being paying Top 10 rates, questions will now need to be asked.

There is clear excess in the system, but there are wider industry changes afoot that will not only radicalize commission payments but the research process itself. Have we reached the age where pensioners will manage their fund direct? Not yet, but as the research content shifts from PDF to internet and becomes more searchable and reachable, asset managers are likely to pick and choose niche services and providers as and when they require them. Fintech will deliver new solutions that will revolutionise how research is consumed in a similar manner to how Google and Apple have transformed how information is accessed. Passive recipients of information are now active, assertive consumers who demand wide access to choice, real time, 24/7.

This will be both positive and negative. While larger asset managers are able to make the requisite investment in technology, smaller boutique players will need to rely on third-party relationships and an increased use of technology to bridge the gap. As the buy-side will have to account for the services they purchase and why, ultimately they will have a greater influence in what research is conducted. As asset managers start to price and value research, only research that is deemed to add value will be consumed – benefiting the end investor – but constrained resources risk limiting full access to research for many in the interim.

The use of dealing commissions does not have to be fatally flawed. Mandated CSAs, budgets and robust payment structures could provide the necessary transparency and increased competition in the research market the regulators seek. There are those that believe CSAs can never work given the lack of industry progress so far. There may be holes in the wall but surely, it is better to identify and fix the holes than smash the wall down in its entirety.

The FCA could be right, this could mean Europe and the rest of the world following suit in breaking the link between payments for research and the execution of trades. Greater transparency many benefit the industry overall in the long term, but changing the payment for research structure will guarantee one thing: continued consolidation of the asset management industry. Whichever way we view this, independent smaller asset managers are at a disadvantage and their demise may not necessarily benefit the end investor. Only time will tell.

Appendix

Methodology

We conducted interviews with 51 head traders of equity desks during December 2014 and February 2015. These firms comprise 44 long-only asset management firms and seven hedge funds, managing €25.5 trillion in assets under management (AUM) worldwide. As with prior years, we segment our participants according to size of AUM, as outlined in the table below:

Firm Type	Large	Medium	Small
Asset managers	>€50B	€10B to €50B	<€10B
Hedge funds	>€2B	€250mm to €2B	<€250mm

Our participants are primarily located within Europe, but we also include firms located in the United States that trade the European markets directly. This year's report contains responses from 76% of the same firms who participated in 2013/4.

About

TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of first-person knowledge, TABB Group analyzes and quantifies the investing value chain, from the fiduciary and investment manager, to the broker, exchange and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can grow their businesses. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, visit www.tabbgroup.com.

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Rebecca Healey

A recognized thought leader in market structure, regulatory reform and financial trading technology, Rebecca Healey joined TABB in March 2011, bringing over 15 years of direct industry experience in e-trading and financial services. Widely quoted in the financial, business and trade media, she has appeared on TV and radio discussing ongoing changes in capital markets for the *Financial Times, The Wall Street Journal, The Times, DeTelegraaf, Het Financieele Dagblad, IlSore24*, *Handelsblatt, Finanz und Wirtschaft, L'Agefi, Le Monde, Les Echos*, CNBC TV, BBC TV, BBC Radio, Bloomberg and Reuters, among others. In 2012, Rebecca was invited to provide evidence for the UK House of Lords review into electronic trading and regularly contributes to wider debates on regulatory reform.

Rebecca has held various sales and trading positions with Bankers Trust, Goldman Sachs and Credit Suisse, where as vice president she was instrumental in launching the firm's successful Advanced Execution Services product to hedge funds from its inception in 2002 until 2008. Prior to this, she was the first electronic trader at Credit Suisse to be registered for all electronic European cash equity markets and covered sales trading into Asia and then Europe between 1997 and 2000. More recently, she was based in the Middle East from 2008 to 2010, employed by the British Embassy in Bahrain where she successfully launched the UK Government's financial services strategy and set up the Bahrain Financial Services Roundtable, which was a key source of information for the UK Government especially in relation to Islamic finance.

Rebecca holds a Bachelor of Arts degree in Spanish and Latin American History and Politics from the University of London.

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