Global
Equities

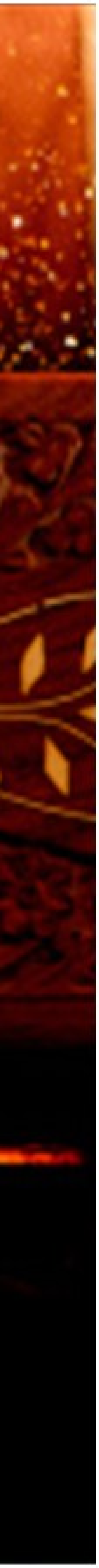
Unbundling:
Opening Pandora's Box

Rebecca Healey & Sayena Mostowfi | V14:034 | June 2016 | www.tabbgroup.com

Vision

The wait is finally over. The European Commission has published the Delegated Acts for the Markets in Financial Instruments Directive (MiFID II) covering proposed governance on operating models, organizational and reporting requirements. Intended to improve market transparency and integrity, the regulation on inducements as well as greater transparency over the quality of execution, costs and charges will ultimately lead to the demise of the bundled service model. While dealing commissions are still admissible in the procurement of research, the level of scrutiny over how client commissions are used and in what manner will impact not only how firms pay for research but the provision of execution itself.

The inspection of services and costs will intensify. Providers of services will only get paid if they add value, but they will also only be incentivized to offer services that are commercially viable. Improved transparency over the costs involved and the value derived from services will lead to a greater quantitative approach to the evaluation of services by sell- and buy-side alike. The increased use of analytics in the validation process will lead to demands to improve standardization performance measurements, as well as who the buy-side selects as their broker. The industry's Pandora's Box has now been opened, and unbundling will have far-reaching consequences not only for the payment of research but for European capital markets overall.



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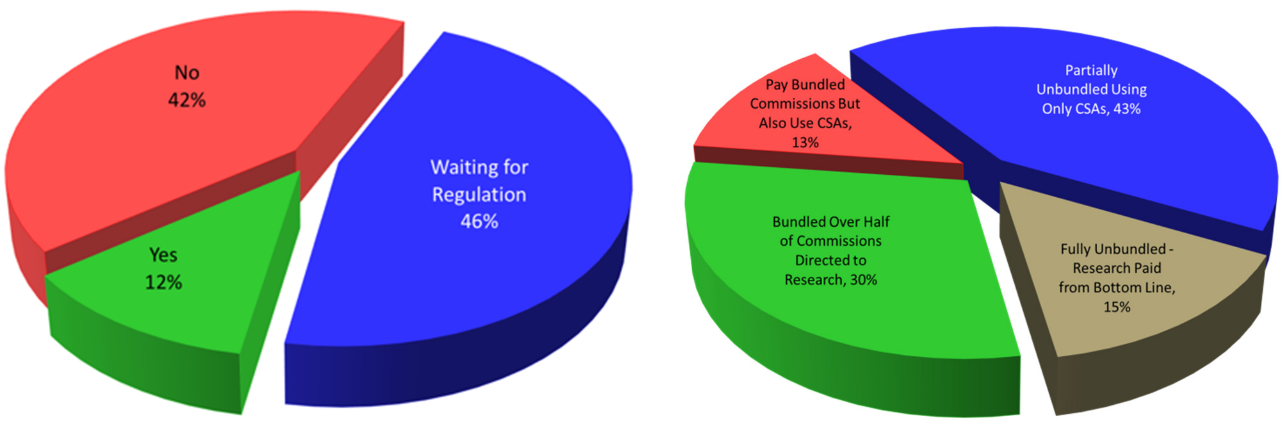
Introduction

The majority of European market participants breathed a collective sigh of relief on publication of the Delegated Acts by the European Commission. Yet this relief may be short-lived. While the use of dealing commissions may still be admissible in an unbundled world, the level of scrutiny over how client commissions are used will demand a dramatic overhaul of current procedures, impacting not only payment of research models but the provision of execution itself. Unbundling is now inextricably linked to best execution.

Exhibits 1 and 2
Participants Who Plan to Implement an RPA/Expectations of Unbundling in 2016



Source: TABB Group

Few participants anticipated the extent of the proposed changes. A mere 12% of buy-side participants who contributed to the research were planning on implementing the proposed Research Payment Account (RPA), and nearly half were still waiting on the outcome of regulation (see Exhibit 1). The majority of the market were banking on the continued use of CSAs albeit with stronger controls.

The challenge is the use of dealing commissions within CSAs are just a subsection of what is now required by the European regulators. While CSAs are likely to remain the preferred option for firms to manage dealing commissions currently, this must now be within the constraints of a Research Payment Account (RPA).

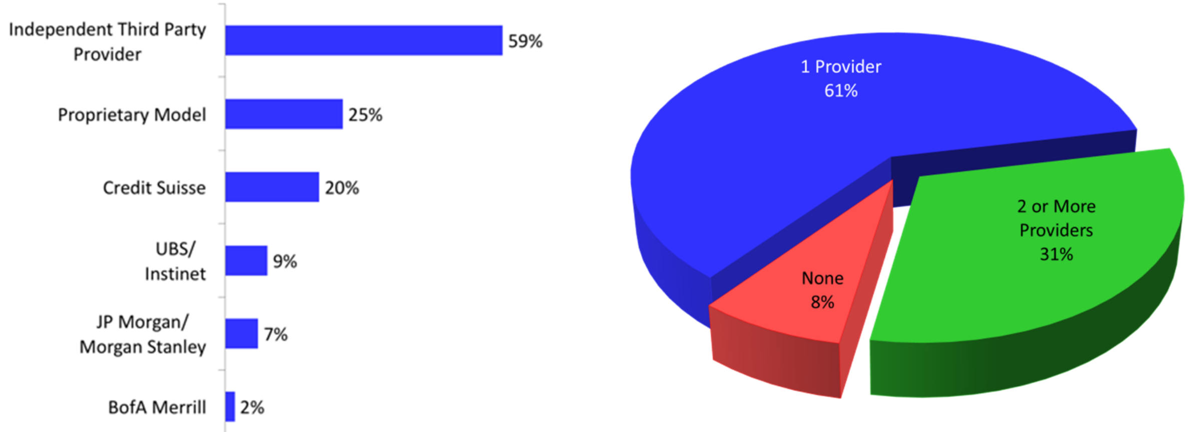
RPAs may only be funded by a specific charge, determined by a pre-agreed budget. Investment firms will need to take ownership of the RPA(s) versus the current arrangements where CSAs are pools of dealing commissions often held by the broker. There are options to outsource this to third party offerings but the underlying asset manager still needs to be sure of both research procured and execution received. This includes evaluating the research and demonstrating the benefit to the fund. In addition, firms are also required to disclose all costs and associated charges. Current bundled service models make it difficult for firms to establish underlying costs; yet just 15% of respondents considered themselves fully unbundled (see Exhibit 2).

Once the bundled interrelationship between buy- and sell-side unravels to the extent the regulators propose, every aspect of the trade from initial investment idea to settlement will come under scrutiny, both in terms of the value derived as well as the cost of provision — altering what is required in terms of brokerage services, and by whom.

To date there has been limited change to business practices across Europe. Firms have mainly continued to expand their usage of CSAs as a redistribution vehicle for fund commissions within specific agreements with brokers. But RPAs require research budgets and evaluation programs with reporting and assessment obligations that are firm-wide. For those already unbundled, this requirement means business as usual, but for others the process is not so clear-cut. Internal checks and balances within the buy-side should eliminate any risk of firms either trading more than necessary to build up the CSA pot, or trading with sell-side firms where a CSA relationship exists rather than looking for true "best execution." The regulators' intention is to break any link between execution and research, as well as demand far greater transparency over the costs and quality of services obtained.

As the unbundling of the research process takes hold, preconceived ideas and market norms are being discounted and the opportunity for challengers to excel is emerging. Broker selection is no longer just an annual review, but a more in-depth and interactive analysis to assess the ability to offer the best, most consistent results for clients. Performance analysis no longer falls to brokers alone to demonstrate — over half the participants now choose providers of independent trade analysis as their best in class, with just one bulge bracket remaining in the top three, and nearly one third now choose to analyze trading performance using two or more providers (see Exhibits 3 and 4).

Exhibits 3 and 4
Best in Class Trade Analysis/Number of Providers



Source: TABB Group

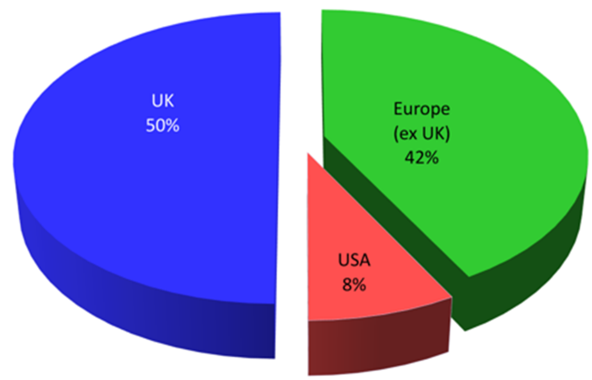
It then becomes a question of what a firm chooses to analyze and why. Transaction Cost Analysis (TCA) alone will only tell you the cost of the trade; the next step will be to analyze the optimal time to trade relative to the underlying objective. As best execution requirements move across the asset classes, the available liquidity and opportunity cost become just as important as the price paid.

Whereas larger buy-side firms are widely perceived to have the technology to conduct more quantitative analysis, smaller asset managers may not have the resources available to scrutinize their brokers to the same degree. Agency brokers and other third-party providers are already clamoring to fill the ensuing void, but whether the provider of analysis can also be the provider of execution services is just one of the many questions yet to be raised and answered as firms endeavor to grapple with the consequences of the regulation.

The process of unbundling brokerage services will impact far beyond Europe's borders. With the asset management industry continuing to consolidate and operate across the globe, changes will resonate universally as firms adopt worldwide models in order to reduce business complexity.

To investigate the full impact of unbundling the research process on order execution, TABB spoke with 48 asset managers trading European equities globally (see Exhibit 5) to establish the regulatory challenges they now face and how they propose to address them.

Exhibit 5
Geographical Location of Participants



Source: TABB Group

Unbundling – The Facts

The main regulatory objectives of MiFID II are to strengthen the protection of investors by removing any potential conflict of interest and to increase transparency for clients over the cost and quality of services they receive. To prevent any conflict of interest, investment firms will now be restricted from receiving or paying inducements. The provision of research will only be excluded as a possible inducement provided:

- The firm pays for the research direct out of its own resources; or
- The firm pays using a separate research payment account (RPA) which is
  - Funded by a specific charge to the client, and
  - Predetermined by an agreed budget with the client/investor, and
  - Regularly reviewed against the quality of the research received.

The RPA, the Budget and the Review

The main debate still centers around the use of dealing commissions within an RPA. The text of the Directive does not rule out the use of dealing commissions, but states that the research charge funding the RPA cannot be linked to the "volume and/or value of transactions executed on behalf of the clients". [1] Instead:

> *"Every operational arrangement for the collection of the client research charge, where it is not collected separately but* ***alongside a transaction commission****, shall indicate a* ***separately identifiable research charge*** *and fully comply with the conditions paragraph 1, points (b) and (c)."*

Points (b) and (c) make clear the obligations of those firms who choose to opt to pay for research using the Research Payment Account, rather than paying for research directly:

> *(b) payments from a separate research payment account controlled by the investment firm, provided the following conditions relating to the operation of the account are met:*
>
> *(i) the research payment account is funded by a specific research charge to the client;*

[1] European Commission Delegated Directive of 07.04.2016

(ii) as part of establishing a research payment account and agreeing the research charge with their clients, investment firms set and regularly assess a research budget as an internal administrative measure;
(iii) the investment firm is held responsible for the research payment account;
(iv) the investment firm regularly assesses the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions.

(c) where an investment firm makes use of the research payment account, it shall provide the following information to clients:
(i) before the provision of an investment service to clients, information about the budgeted amount for research and the amount of the estimated research charge for each of them;
(ii) annual information on the total costs that each of them has incurred for third-party research.

Therefore, while dealing commissions technically can still be used, we are a long way from current processes. Firms not only need to be transparent over the cost of research they procure, they also need to establish the value derived from the research — in advance.

To ensure that clients are aware of costs and charges to be incurred before services are provided, the RPA can only be funded according to a pre-agreed budget. However, as above, the research charge can be estimated ex-ante. Then, as any costs and charges can only reflect a client's actual investment, charges will be reassessed ex-post to ensure any research budget is not exceeded and any excess funds are returned.

Firms that cannot use client money must pay for research directly or fund the RPA themselves. With a CSA, the investment firm is not holding the client's money, but often the broker with whom they have the CSA agreement holds the money on their behalf.

Investment firms that can use client money may then have to determine how they can adapt the European regulation in order to replicate processes globally and ensure they are not unfairly disadvantaging one group of clients.

Once the policy is in place, then the cost has to be agreed with the client as well as the frequency with which the charge will be deducted from client resources over the year. Any increase in the research budget may only occur after the client has received clear information about any intended increases.

However, more importantly, firms must not only disclose the cost of research but the value derived from the research and how this has contributed to better investment decisions for the fund. Payments accrued are only admissible where there is justification of an additional or higher level of service provided, and clients must receive a comprehensive overview of the relevant information regarding those services. Firms must regularly assess the quality of around CSAs, these may represent the most expedient way forward in the interim.

Disclosure of All Costs and Associated Charges

Future disclosure will not only affect the provision of research. Under the latest Delegated Regulation firms must disclose all costs and charges related to the investments on a "personalised" basis (see Exhibit 6):

> *"In order to improve transparency for clients on the associated costs of their investments and the performance of their investments against the relevant costs and charges over time, periodic ex-post disclosure should also be provided where the investment firms have or have had an ongoing relationship with the client during the year. Ex-post disclosure on all the relevant costs and charges should be provided on a personalised basis".* [2]

Exhibit 6
Disclosure of Costs Required by Investment Firms (Annex 2, Table 2)

Cost Items to Be Disclosed		Examples
One-off charges	All costs and charges (included in the price or in addition or the price of the financial instrument) paid to product suppliers at the beginning or at the end of the investment in the financial instrument	Front-loaded management fee, structure fee, distribution fee
Ongoing charges	All ongoing costs and charges related to the management of the financial product that are deducted from the value of the financial instrument during the investment in the financial instrument	Management fees, service costs, securities lending costs and taxes, financing costs
All costs related to transactions	All costs and charges that are related to transactions performed by the investment firm or other parties	Broker commissions, entry- and exit charges paid by the fund, markups (embedded in the transaction price), stamp duty, transactions tax, and foreign exchange costs

Source: European Commission – Annexes to the Commission Delegated Regulation Supplementing Directive 2014/65/EU

Questions still remain on what exactly a "personalised" basis means given the differences between a "natural" person and a "legal" person identified in other MiFID II text. The difference here could be substantial if costs and charges are expected to be drilled down to an individual level; asset managers currently do not even hold individual information when selling via a distributor. A more pragmatic argument would be to ensure that at a legal entity level, firms are confident that all costs and charges relative to the fund are transparent.

Furthermore, the best execution policy not only has to be put in place, it needs to be made available in an accessible form to all clients, and to a sufficient level of detail (see Exhibit 7, next page).

[2] European Commission – Annexes to the Commission Delegated Regulation Supplementing Directive 2014/65/EU

Exhibit 7
Execution Policy Disclosure Requirements

	Minimum Disclosure Requirements		
Publish Order Execution Policy	Detail how orders will be executed according to class of instrument and client type	Provide link to most recently published execution quality data	Identify Trading Venues accessed
Demonstrate Adherence to Policy	Monitor effectiveness of execution policy on a regular basis	Demonstrate that firm has followed its Execution Policy upon request	Provide public assessment of venues accessed
Reporting Obligations	Annual summary of top 5 Execution Venues used in preceding year – per instrument	Summary of the analysis and conclusion drawn from the monitoring of the quality of execution per instrument	

Source: European Commission – Annexes to the Commission Delegated Regulation Supplementing Directive 2014/65/EU

Finally, firms that provide both execution and research services must price and supply these services separately, and the supply of these services should not be influenced by, or be conditional on, levels of payment for execution services. Full unbundling has finally arrived.

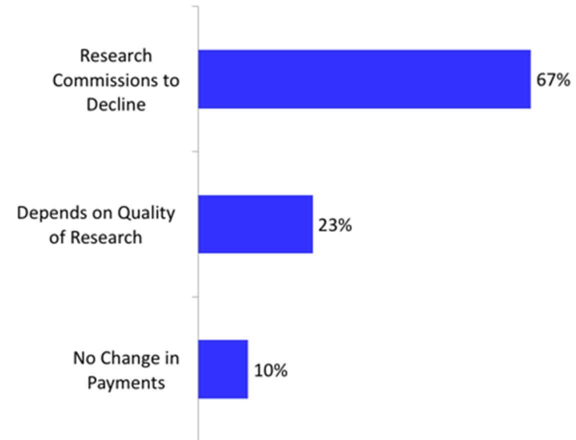
The Regulatory Impact

Although much has already been written about the regulatory impact on research evaluation and acquisition[3], the overhaul of what is purchased, how, and why will have wider ramifications than research provision alone.

The Research Decline

In 2015, 67% of asset managers anticipated that commission payments would decline (see Exhibit 8) and the effect of this is already being played out in dealing rooms across Europe.

Exhibit 8
What is the likelihood that your total research payments to brokers will decline (2015)?



Source: TABB Group

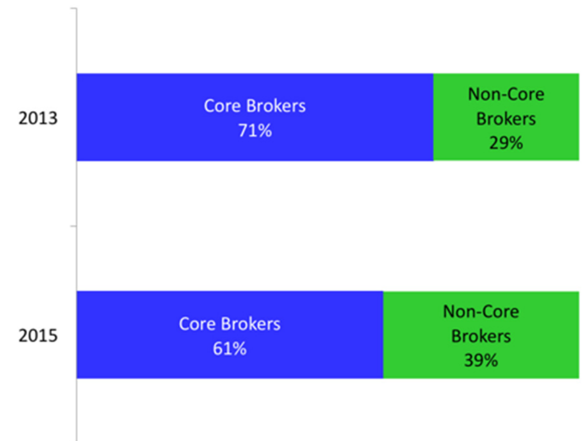
Wider industry changes such as the rise of passive indexing have challenged traditional revenue streams for global investment banks. Now the dwindling return on investments is forcing the sell-side to rethink the services they offer and to whom, and the value they attribute to these services. Similarly, the buy-side is now under greater accountability as to the services it selects. All these factors will result in a rebalance of the traditional buy- and sell-side brokerage relationship.

As the cost of research provision is exposed, firms can elect not to provide research, or their customers can opt not to take the research provided. If the buy-side decreases its external research spend, internal resourcing may increase but ultimately leads to a decline in sell-side investment in research provision, which in turn leads to a further fall in revenue opportunity for the banks. The declining investment in research departments then makes the provision of suboptimal waterfront coverage an unfortunate outcome and an expense that is hard to justify. This in turn forces the sell-side to improve the quality of what is available or become more selective about what to offer their clients.

[3] See TABB research "**The Changing Face of Equity Trading: Paying for Research**," March 2015

There is an argument that the cost of providing research remains far higher than is necessary. As the industry adapts and evolves, different methods of producing, accessing and evaluating research from a wider range of participants will emerge. There will be an increased use of electronic communication, data analysis, buy-side analysts or even a more global approach such as offshore research teams. However, while any changes in research provision will take time to reposition, the effect of a decline in research revenues is already hitting home, impacting not only the global investment banks but also their clients as well as rival providers of services within the capital markets ecosystem.

Exhibit 9
Average Proportion of Commission Dollars to Core Brokers



Source: TABB Group

Rebalancing the Ecosystem

As global investment banks retract, agency, regional brokers and independent research houses are slowly encroaching into the emerging void. Global investment banks can no longer automatically offer the full suite of services, and the buy-side is forced to pick and choose the services they require and from which providers. A new era of specialization is therefore emerging, sometimes facilitated by independent research providers, sometimes by a regional "axe" in a stock. The window of opportunity for challenger brokers is widening quickly; the proportion of commission dollars going to core brokers declined by an average of 10%, from 71% in 2013 to 61% in 2015 (see Exhibit 9).

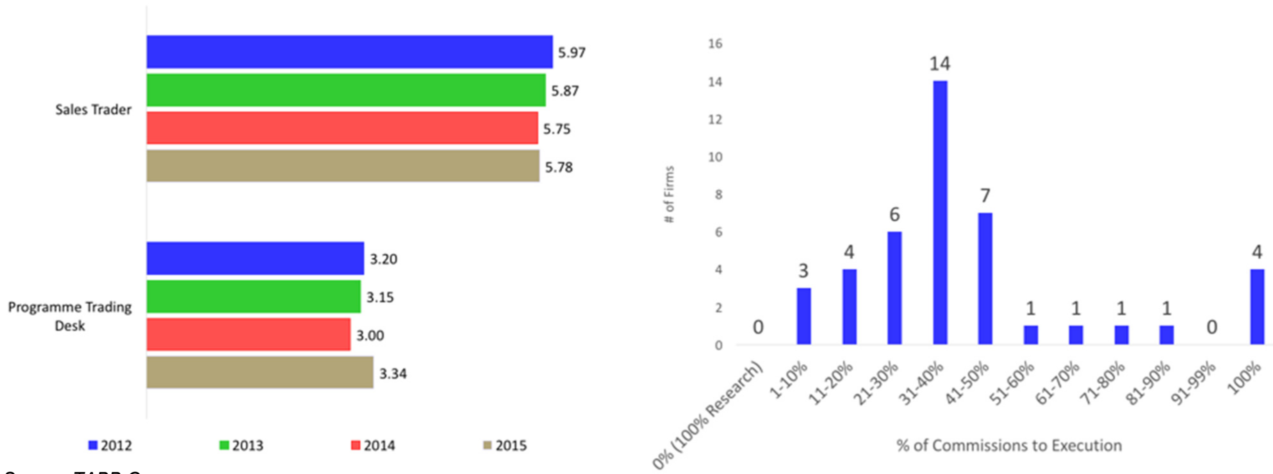
As research moves from its one-size-fits-all waterfront coverage approach to a greater menu of varied specialties, the power is shifting from the provider of research to the consumer of research. Those with the largest wallets can now control the distribution and levels of accessibility. In addition, the services they require in terms of execution will simultaneously shift, impacting the eco-system still further. Without the automatic accumulation of liquidity in exchange for research ideas, global brokers lose their predetermined research relationship and hold over the buy-side.

Rise in Cost and Scrutiny of Execution

On top of capital and balance sheet pressure from regulators and shareholder demands for an improved ROE, the automatic dominance by global brokers is coming under fire, fueled by the decoupling of research procurement from execution. Under Article 27(7) of Directive 2014/65/EU there is an obligation for all investment firms to monitor the effectiveness of their order execution arrangements and policies and assess these on a regular basis. Traditionally, execution performance has always depended on the venue selected, the order in question and the liquidity currently available; now the loss of the bundled service model exposes the quality of individual services provided and the value determined by the users.

For European funds where the portfolio is diverse across country and sector, participants may struggle to source liquidity when it is required if they trade a high percentage of small- and mid-cap stocks. The loss of access to broker capital and the potential loss of riskless principal activity and the demise of broker dark pools are constraining a broker's ability to facilitate client order flow. As a result, the industry is beginning to witness an upturn in the cost of quality execution provision (see Exhibit 10). As the amount spent on research declines, a larger proportion of the commission pool is being spent on trade execution rather than the traditional 70/30 split between research and execution (see Exhibit 11).

Exhibits 10 and 11
High Touch Execution Only Average Commission Rate (bps) 2012-2015 / Percentage of Client Commissions Used to Pay for Execution



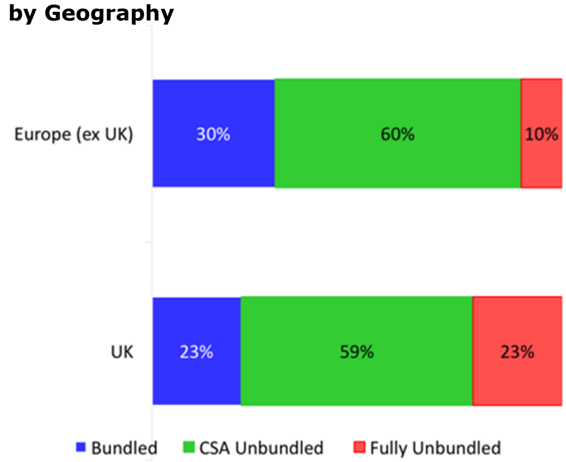
Source: TABB Group

Although varying the commission model between high- and low-touch trading is nothing new, the incorporation of different commission models according to the complexity of the trading or the quality of the liquidity provided will lead to operational challenges. The result will be an increase in requirements for buy-side technology. As just one example, under CSDR, an order management system (OMS) will need to be able to attribute multiple commissions to different child-order fills in real-time *and* maintain full STP to meet reporting obligations post trade *and* include trade reporting, confirmations *and* ultimately, trade settlement.

Moving from CSA to RPA

Shifting from a predominantly CSA-managed research and execution program to full unbundling will be a steep challenge for many firms, given that just 10% of European participants in 2015 perceived themselves as fully unbundled currently versus 23% in the UK (see Exhibit 12).

Exhibit 12
Breakdown of Commission Unbundling in 2015 by Geography



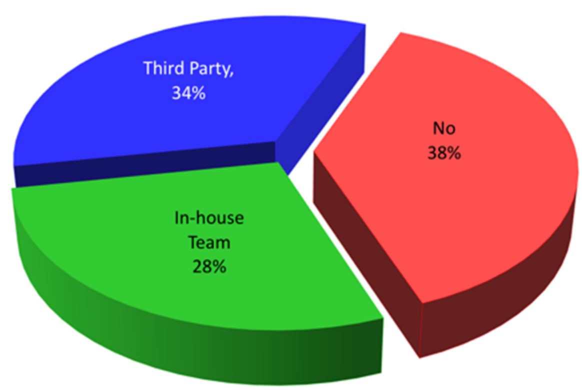
Source: TABB Group

CSAs are a mechanism for collecting and then sharing commissions across brokers to pay for research but this is a small subsection of what is now required. Purchasing research using an RPA will require transparency over budgets and funding as well as the means to assess and report on the quality of research procured.

Adapting CSAs as they stand is set to become an administrative headache. Currently when sufficient revenue has been generated from dealing commissions to meet research budget requirements, the dealing desk switches to an "ex-only" rate. Although this provides a clear delineation between paying for research versus execution, and theoretically enables a firm to execute with any broker provided they have sufficient execution capabilities, the extent to which transparency is now required over individual costs and charges potentially renders current processes extinct.

Firms are already moving from firm-wide single CSAs to multiple CSAs at a team or strategy level in order to manage potential cross subsidisation issues. Although it remains challenging to separate research allocations at a firm level; to keep this at a strategy level means that an investment team can absorb research and then allocate this fairly across the funds they cover.

Exhibit 13
Use of CSA Aggregators



Source: TABB Group

The additional challenge with individual CSA programs is that they can only see a portion of activity — funds can be included or excluded post trade and there is no visibility over the research consumed upstream. As such, nearly two-thirds now use CSA aggregators to achieve greater oversight across the street (see Exhibit 13).

Over 60% of respondents now have access platforms which enable firms to virtually aggregate and manage commission credits and pay research providers according to broker vote allocations. Aggregators lower overall costs for the buy-side to manage the commission payment process as well as reduce the number of errors and mispayments. In today's competitive environment, control of errors as well as unnecessary costs count. However, there is also the need to actively measure and quantify where firms are receiving value for their money.

Not only must asset managers inform fund clients of just how much money they will spend on research by setting up a research budget and provide an estimated research charge ex-ante, they must subsequently provide a breakdown to show how clients' funds were spent on an annual basis (ex post). This must include regularly assessing the quality of research they consume to ensure it improves the decision-making around their investments.

While shoe-horning CSAs into an RPA framework to meet additional requirements appears taxing, there are added complications related to the RPA itself. The RPA can only be funded by client money whereas CSAs are often held with the broker. As of yet, firms are unsure whether they will need one agreement per firm, or multiple. Will asset managers be forced to set up an RPA with each broker-dealer with separate accounts for commissions and research for each fund/client? Current operational challenges around CSAs in balancing broker research payments have the potential to turn into an operational nightmare under RPAs.

Fund managers will also need to take into account the funds under management and their legal jurisdiction. Global asset managers with funds domiciled in both Europe and the US must choose between implementing the European regulatory regime globally and struggling to divide research payments in their OMS between the two types of clients.

Hence some firms are moving toward direct payments. For large-scale pension funds the benefits of greater transparency in how research commissions are spent, and on what, are immediately evident. But as with much else under European regulation, it will ultimately depend on the underlying firm and the type of investments and trading activity in which that firm is involved and where. RPAs, CSAs or even paying direct from the bottom line are all methods with challenges and will all necessitate increased resources, investment, governance and oversight. Of the longer-term effects and supposed benefit on research consumption — only time will tell. In the meantime, firms are focusing on the value derived from the execution process.

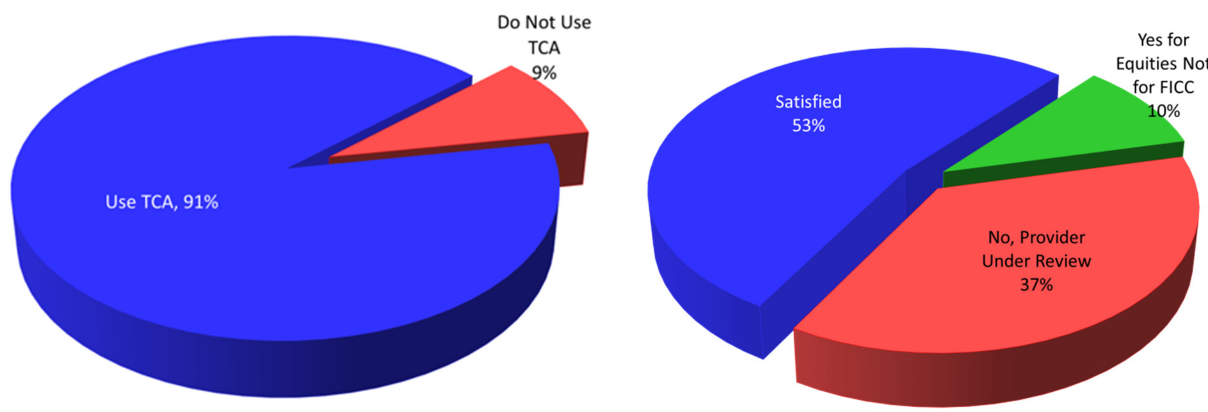
TCA Mark 2

Establishing the value of execution was once relatively straightforward. The portfolio manager had a target price and the dealer's job was to meet or beat that target objective. In the post-MiFID world, all costs and charges related to the transaction must be transparent. Investment firms must also provide clients with information on the cumulative effect of costs on return when providing investment services, both on an ex-ante and ex-post basis. In addition, the information must be based on all charges and provided on a personalized basis.

"Transactions costs and ongoing charges on financial instruments should therefore also be included in the required aggregation of costs and charges and should be estimated using reasonable assumptions, accompanied by an explanation that such estimations are based on assumptions and may deviate from costs and charges that will actually be incurred."[4]

It is important to note European regulators do not mandate the use of TCA — just the disclosure of all costs and charges. Nevertheless the use of transaction cost analysis in equities is now widespread, with over 90% of contributors using TCA in some form (see Exhibit 14). But dissatisfaction with current TCA offerings is growing; just under 40% are now reviewing their current TCA offering, either for all asset classes or just for Fixed Income and Rates (see exhibit 15).

Exhibits 14 and 15
Use of TCA in 2015/Level of Satisfaction with Current TCA Provider



Source: TABB Group

As the structure of trade formation moves from the principal to the agency model, the industry is moving to an order-driven market based on managing costs and demonstrating the provision of best execution. This in turn is adding responsibility for best execution onto the buy-side. While this change does not negate the responsibility the sell-side owes the buy-side in terms of execution, it is forcing the buy-side to rethink what questions they should be asking about best execution, and whether TCA can and should deliver.

[4] European Commission Delegated Regulation of 25.04.2016

However, TCA in and of itself cannot deliver all aspects related to best execution, and therefore some on the buy-side are increasingly looking to the pre-trade selection of venues rather than a post-trade verification, and are looking to vendors for improved offerings. The challenge for the providers is that while some asset managers are on the cutting-edge of technology, many firms still have to get on, let alone get up, the TCA curve.

While regulators may only be looking for clarification of a firm's top 5 brokers, the information to be provided within the execution reports is more than is currently provided. The complexity of establishing what internal firms may look for above and beyond regulatory obligations creates additional challenges. Buy-side dealing desks may have different internal clients each with their own objectives, including the fund managers, portfolio managers, compliance officers and senior management. Desks need to establish where, when and why outlier trades are occurring and if this matters to the overall performance of the fund. For example, if a trader is always missing VWAP by 1bp in Norway, does this matter to the desk, to the PM, or the firm as a whole; and what processes and procedures should be addressed to amend this?

When TCA is possible at the parent level, a wider and more accurate picture can emerge of the overall cost of execution. At a child-order level, brokers and third-party providers might only see a portion of the full order information, whereas the buy-side can review the whole life cycle of the order during its execution — from inception of the trading idea to settlement, which will ultimately deliver a different result for the end investor.

However, the gulf between what vendor products are available now versus what is required becomes self-evident when looking at TCA across the asset classes. Dealing desks are asking how they can accurately measure costs, what benchmarks should be used and for what scenarios, and at what starting or end points. Even when just reviewing equity trading, the lack of standardization of industry definitions means that while a standard interpretation of a VWAP trade may exist, the analysis provided may skew results due to different interpretations of where measurement should begin or end. While a basic TCA should measure costs listed against a set of benchmarks to establish performance and measure quality, the question is now what to measure, and how the industry can agree on standard terminology to avoid confusion when comparing results.

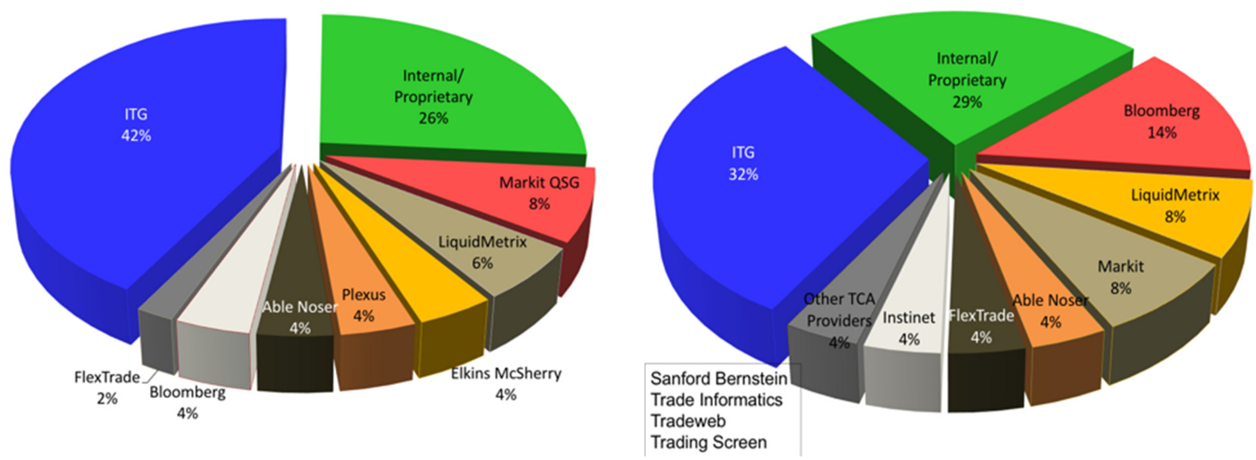
Users of TCA need to agree on how to factor in implicit costs such as delays in executing a trade; at what point is the order accepted — at the PM level, at the decision to trade, or at the point of in- or outbound receipt messages? How is opportunity cost measured if a trade fails to execute? All these questions and more take on a new significance if the ultimate aim is to deliver best execution to end clients, especially when this requires publication on an external website.

While the regulators may claim that this is above and beyond the original intention, Pandora's Box has now been opened, and demands for analysis and interpretation are emerging from every division and every aspect of trading. The need to deliver greater standardization in the methodology and measurement of best execution may slowly be alleviated through the improved provision of data and the introduction of harmonization of FIX Protocol standards such as Market Model Typology (MMT) across all trading activity, including OTC and voice activity, but there is still more that can and must be achieved.

Even today not all brokers provide the necessary data in relevant FIX tags. There is still a lack of consistency and clarity around the construction of data sets. Without the capital-intensive stranglehold on the market, agency brokers can start to push through and demonstrate their willingness to provide the full transparent data to third-party providers. Enhanced data and standardization around FIX tags to establish in what capacity your counterparts acted (agency, principal or SI) will be essential to providing the buy-side with greater knowledge in order to make more informed choices over execution.

Hence there is the continued use of third-party TCA providers; although ITG remains the number one provider in Europe for the participants contributing to this research, new challengers are continuing to emerge to take market share as market participants demand more from their providers such as Bloomberg, LiquidMetrix and Markit (see Exhibits 16 and 17).

Exhibits 16 and 17
TCA Providers 2013 to 2015



Source: TABB Group

The demand for more from third-party analysis will only increase post MiFID II. The deluge of data within an increasingly fragmented and opaque environment will make reading through the volume of noise challenging. For example, the introduction of opaque Systematic Internalisers compares badly with the loss of the BCN with its FIX tags of 29, 30 and 851, and leaves many buy-side dealing desks scratching their heads. If one of the primary objectives of MiFID II is the ability to ensure best execution is achieved for the end client, how can this be achieved without fully understanding the order execution process behind a broker's SI? In addition, the data to be produced under RTS 27 currently includes all unexecuted orders and quotes, making it almost impossible to establish the level of truly intractable liquidity from market noise.

The only option for firms will be an increased reliance on data analysis and third-party providers or even bringing analysis in-house to ensure an effective and rigorous review of brokerage services provided. Ultimately it will come down to what level of granularity an individual firm or dealing desk wishes to go. Execution analysis within an organization could very easily become an industry in itself and firms have to establish what they want from their TCA and how extensive its use matters within their organization, or even whether it matters at all.

What Lies Ahead

The regulators' attempt to prioritize greater transparency over the cost of and quality of research and execution have opened Pandora's Box and will radically reshape the European capital markets. The world at large would not contemplate paying for bundled services without having a clear understanding of what they were paying for and why. Nor would businesses be able to continue operating at a loss simply because they should have market share. The traditional dominance of the global brokerage industry of old is long gone.

The likelihood is that even without a direct ban on the use of commissions to pay for research, firms will slowly gravitate to paying for research direct. Trustees of pension fund mandates are rightly questioning whether they should be paying for research; the issue is the consequences of unbundling payment for research are as yet unknown. Perhaps firms will include the costs within their management charges; perhaps some clients will refuse to pay for research — will firms then be unable to charge any client if one tranche of clients refuses to pay to ensure all clients are treated fairly? These outcomes have yet to unfold; what is certain is that the management of the payment process will challenge most buy-side dealing desks' current resources.

Inclusion of CSAs within an RPA framework appears to create an additional layer of complexity; therefore some firms are beginning to ask whether this is the most effective use of increasingly scant resources in addition to incurring a high probability of error. While the benefits of greater transparency in how research commissions are spent and where are self-evident; it will ultimately depend on the underlying firm, the type of investments and underlying trading activity that will indicate how firms choose to respond. CSAs in RPAs, stand-alone RPAs or even paying direct from the bottom line will all necessitate increased resource, investment, governance and oversight.

Buy-side or sell-side, only firms with products that can provide optimal value at minimal cost will survive. The outcome will be to build on quality over quantity, creating an industry where investment managers pay only for what they want at a price based on a transparent fee structure from research to market data. But as the bundled model dissolves and firms focus on specialization, the need to improve research offerings will also inadvertently mean the need to improve execution quality.

Sell-side firms now have a regulatory obligation to determine what price to charge for a component. Some would argue that the move to explicit pricing may impact liquidity, resulting in less efficient capital allocation by traditional means, forcing yet further change in liquidity formation. As ownership of liquidity becomes decentralized, greater importance is placed on quality of execution and correct pre-trade selection rather than mere post-trade verification.

While the regulators may be focused on the fidelity of the execution process to enable firms to make informed choices based on sound rationale, it will also be important for the firms to demonstrate what they do when an execution process is not working and how they are able to bring either the broker or the underlying venue to account, when required. As a result, the growing sophistication of equities TCA will become amplified across the asset classes, as will the importance of creating an audit trail to evidence best execution for not only equity but also equity-like and non-equity assets.

Some asset managers outside of Europe with local or regional clients believe they will not be affected. However, it is difficult to envisage how firms will be able to segregate accounts for European clients from those of North American or Asian clients, even without considering the implications of fiduciary obligations, or managing transparency over cross-subsidization to ensure non-European clients are not paying for research used anywhere else.

Economic realities continue to impact European capital markets. A small difference in fees can make a huge impact on returns for the ultimate beneficiary, the end investor. For funds that do truly outperform, justifying research expenditure will not be an issue as performance statistics still matter. But rising competition from exchange-traded funds and robo-advisers is putting active managers under pressure to prove their value and justify higher fees; increasing the transparency from research to execution and from costs to performance will be just the start.

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 joined TABB Group in March 2011, bringing more than 15 years' experience in e-trading and financial services. Rebecca has held various sales and trading positions with Bankers Trust, Goldman Sachs, and most recently Credit Suisse, where as Vice President she was instrumental in launching the successful AES 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, Rebecca was based in the Middle East from 2008 to 2010. There she was 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 remains a key source of information for the UK Government today, especially in relation to Islamic finance. Rebecca holds a Bachelor of Arts degree in Spanish & Latin American History & Politics from the University of London. At TABB Group, Rebecca has authored *Dark Matters; One Touch, One World: The Future of Investment Banking; FX in Transition: Taking The Quantum Leap; MiFID II and Fixed-Income Price Transparency: Panacea or Problem?; Market Surveillance in Europe: Under Starter's Orders; European Equity Trading 2011/12: Looking for Allies in the Face of Adversity;* and *European Algorithms: The Evolution; and Trading in the Middle East: the Road to Mecca.*

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Sayena Mostowfi, Principal and Head of Equities Research, has more than fifteen years of experience in the securities business, with expertise in market structure, electronic trading and trading systems. Prior to joining TABB, Mostowfi was managing director of strategy and business development at Sun Trading LLC, a proprietary trading firm. During her three years at Sun, she developed and optimized US and European trading relationships with exchanges, dark pools, index providers and other broker-dealers. Mostowfi started her career at the Chicago Stock Exchange in 2000. During eight years at the exchange, she held relationship management, product management and strategic planning positions. As vice president of strategic planning, she participated in historic market structure changes at the exchange, including pre-Regulation NMS inter-market negotiations, demutualization from membership structure, and the transformation from a floor-based exchange to an ECN model. Mostowfi received a B.A. in English from the University of Michigan.

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