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8 Really Important Things You Might Not Know About MiFID II

The far reaching impact of the new European regulations

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It's been a long time coming but MiFID II (MiFID) is almost upon us. Most people in the industry have been aware of the impending regulations for many years, but were able to brush it aside for a variety of reasons: the implementation date is far in the future / it's been delayed / we are waiting for further guidance / it might get delayed again… but now it has become a reality and brokers, asset managers and vendors are hurrying to comply with the directives scheduled to go into effect in January 2018.

By now everyone understands that MiFID II will fundamentally change the business models of brokers and asset managers by unbundling research from execution. In addition the rules also include significant new requirements around pre-and post-trade transparency, transaction reporting, trading venues, best execution, record keeping and surveillance. See recent Greenwich Associates research here for more information.

Yet despite all the focus on MiFID, the plethora of news articles, and the cacophony of seminars, webinars and pop-up events, there are still a few things you might not know about MiFID:

1. Dark Pool Caps could be breached on day 1 of MiFID. The regulations impose volume caps on dark pool executions of 4% in any one venue and 8% across all venues. If these thresholds are breached, dark pool trading in that security is suspended for six months. This much is well known, but what is less well known is that the calculation is based on a rolling 12 month window (which has already started). Many stocks are trading at over 8% in dark pools already, and if that continues throughout the year then the cap will be breached on day 1. However:

2. Regulators don't have a good way to enforce the dark pool caps. Because there does not exist a consolidated tape in Europe that identifies dark trades. They will likely have to rely on venue self-reporting but have not given any guidance on this.

3. U.S. brokers are prohibited from accepting a 'hard money' check. Under U.S. regulations, to accept a payment for research that was not generated by commissions, would require them to register as an investment advisor. They are reluctant to do this as it would impose significant, duplicative regulatory burdens and constraints around proprietary trading and client facilitation. While only 18% of European institutions expect to switch to hard payments, they could potentially see themselves cut off by US brokers. Additionally, there is some doubt whether funds when swept from a CSA to an RPA can still be considered commissions. If not, then US brokers will be prohibited from accepting checks from an RPA account.

4. Asset managers will need to pay for CSA/RPAs. Currently asset managers in Europe do not pay explicitly for CSAs – the cost is either borne by the broker or a small fee is charged on each payment made. Under MiFID rules, absorbing the cost of a CSA would be considered an inducement to trade and will be prohibited. In 2018 CSA funds will need to sweep into an RPA and European asset managers will have to pay a fee for each CSA/RPA – likely a fixed annual cost.

5. Research sold in Europe may be subject to VAT. Value Added Tax is a form of sales tax in Europe. When research is paid from commissions it is VAT exempt, but when it is paid for from hard dollars it will become VAT liable unless an exemption is negotiated. In the UK, for example, this would add 20% onto the cost of research.

6. Asset Managers are Planning Significant Rewrite of Legal Agreements. The changes that MiFID will bring about as so fundamental that they will likely require asset managers to re-write their Investment Management Agreements and amend their Form ADV. This task alone is a significant undertaking for legal departments.

7. Avoiding Cross-subsidization of Research will be a Major Headache. Cross subsidization would occur when research paid for by one fund is used to the benefit of another fund. This could happen unintentionally when a PM sits in on another PM's analyst meeting. And there are huge challenges to ring-fencing research by client. For example, if different clients of the same fund/strategy agree to different research budgets. Or if the fund/strategy has EU clients and non-EU clients – bundled research for non-EU clients cannot be used to benefit unbundled EU clients.

8. Research Delivery will go from Push to Pull. Turning research off will be a big initiative for asset managers at the end of the year. The current research model involves brokers pushing as much research as they can to a client. In 2018, if a portfolio manager or analyst receives research in their inbox that they did not ask for or budget for they could be in violation of MiFID II. As such asset managers will ask brokers to stop sending research, control access to their research portals and instead will pull research from brokers as needed.

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