Callan

Examining MiFID II After Implementation

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Last August Callan outlined some of the issues raised by MiFID II, the second iteration of the Markets in Financial Instruments Directive. We wanted to provide an update on the directive, which took effect at the start of this year.

First some background. MiFID II is a European Union regulation that affects all European banks, fund managers, retail investors, pension funds, hedge funds, high-frequency traders, and exchanges and applies to equity, fixed income, commodity, currency, ETF, and futures markets. It also affects U.S.-based managers with operations and portfolio management teams in Europe.

It mandates that investment firms charge separately for research and brokerage services to avoid conflicts of interest. It also limits the trading volume in any one stock that changes hands within private markets or "dark pools" to 8%, and it provides pricing transparency for off-exchange markets. This affects how investment research is paid for, how trades are executed and documented, as well as how brokers share information, find the best prices, and pay one another.

Its intent is to promote more transparency and confidence in the financial markets in response to the Global Financial Crisis.

What Has Been the Response?

While the legislation requires transparency, investment managers can choose how to allocate their unbundled research costs—either proportionately to clients or absorbed at the firm level, which has been the more common response. Although the United States has not introduced similar legislation, some U.S.-based managers have incorporated MiFID II requirements across their client base.

Impact

The most direct impact is the unbundling of investment manager research costs. Managers affected by the regulation will now be required to budget research and trading costs separately.

Disaggregating trading and research costs as well as the reporting required may increase total costs for investment managers. This could disadvantage smaller organizations with fewer resources. Additionally, the sell-side community may be impacted by the need to offer separate services, perhaps leading to fewer sell-side research firms remaining viable for the investment management community.