Vanguard

MIFID II – INVESTMENT RESEARCH Q&A

1. What changes are being made to investment research as a result of MiFID II?

MiFID II considers research provided by a Broker, to be an inducement and, as such, it must be paid for explicitly. MiFID II also expands the definition of research to capture materials outside of published research that contain a 'buy' or 'sell' recommendation.

It should be noted that MiFID II bans a number of other inducements being received by asset managers of which research is a core element. Other forms of inducement include receipt of services from counterparties which are not offered widely to other firms (e.g. direct wires, IT messaging and data services).

2. Why are these changes being implemented?

The regulator is of the view that the quality of research may unduly influence a firm's counterparty selection when executing a trade. As such, the regulation aims to detach investment research entirely from execution by ensuring firms pay for it separately. This prevents firms from sending disproportionate volumes of trades to counterparties that provide them with the best research (i.e. induce them to trade).

3. Does this impact Europe or is it a Global Issue?

Research providers are permitted to send research free of charge to Vanguard outside of the EU. Whilst it can continue to be received without charge outside of the EU, it cannot enter the EU and/or be used to support portfolio management decision making for European domiciled funds managed in other regions. If Vanguard were to only pay for research within the EU it would severely disrupt our existing business model as the European entity would need to be ring-fenced.

4. How do the new investment research requirements under MiFID II impact existing SEC rules?

There are significant inconsistencies between the EU regulators and the Securities and Exchange Commission (SEC) with regard to the consumption and payment of research. Under SEC rules, where a broker accepts payment for the provision of research, they are deemed to be an investment advisor. As such, the broker is not able to trade on a principal basis with the client (i.e. Vanguard). This is in direct conflict with the MiFID II requirements, which require Vanguard to pay its brokers for research. Therefore, in the current state, if Vanguard complies with MiFID II in the US it contravenes SEC rules and vice versa. In Novembver 2019 the SEC issued a 3 year extension to its no action letter of October 2017 (to July 2023) to assist US market participants in their engagement with the MiFID II rules on research. The extension letter confirms the ability of broker-dealers to receive payments for research through client commission arrangements and this will allow EU authorities to continue the evaluation of the effects of MiFID II and potentially any modification to the rules, and the possibility of an equivalent regime in the US and EU.

5. How will Vanguard continue to receive research globally whilst not breaching SEC or MiFID II requirements?

While MiFD II does not place direct obligations on non EU firms, in the UK, Vanguard needs to be perfectly transparent around their research consumption and spending and has established a research services agreement with third party research providers to ensure that the services received are not considered an inducement. External Research received by Vanguard's non EU business is outside the territorial scope of MiFID II and will not be subject to the inducement and research rules, therefore Vanguard Crew located outside of EEA markets may continue to receive external research consistent with the applicable laws and regulations in that region.

Sharing of External Research from Crew operating inside an EEA market with Crew operating outside an EEA market is permissible subject to the applicable laws and regulations in the receiving country however any research received by the non-EEA firm cannot be shared freely with the UK office and any redistribution must be paid by the EU investment manager.

6. How has Vanguard determined which research to pay for?

Commercial negotiations have taken place with a number of Firms that Vanguard considers provide research that is critical of value to our business in Europe. Research providers are added and removed on an ongoing basis, if the portfolio managers can provide appropriate investment justification for their inclusion / exclusion.

The UK regulator allows Vanguard to take free three-month trials with providers to help us decide. This can be used to discover content from providers we are not familiar with and it will help with the procurement process.

7. How is Vanguard looking to pay for research and why was this approach adopted?

Vanguard has chosen to pay for research from its own profit and loss account. This means that the costs of investment research will be absorbed by Vanguard as opposed to being passed on to the client directly. This is in line with Vanguard's principles.

8. Who will bear the increased costs of investment research?

Investment research will constitute another cost of doing business for Vanguard. Similar to the cost of Bloomberg terminals and other supporting infrastructure, the costs will not be assigned to a specific set of funds. Instead, they will be paid for from Vanguard's P&L (of which management fees are the predominant source of income).

9. How / when will Vanguard disclose its annual spend on investment research?

The amount Vanguard chooses to spend on investment research is an internal decision taken to ensure we have the relevant inputs to benefit our clients. These costs will be managed internally to ensure we are receiving value for money and, as such, these costs will not be disclosed publically. This is because we do not want the research providers to know how much we have to spend annually as this will disadvantage us in any subsequent negotiations.

10. Will the list of research providers remain static?

Vanguard will continue to assess the research received to ensure it is fit-for-purpose, and continues to add value for our clients. This may include turning off existing providers or negotiating with new brokers. In addition, we will continue to assess the option of bringing research in-house for certain areas.

11. How will Vanguard prevent unsolicited research entering the organisation?

Formal communications are sent to the research providers Vanguard does not wish to continue receiving research from, instructing them of our decision and requesting they halt sending Vanguard all future research.