MIFID II: CHANGING THE TERMS OF ENGAGEMENT FOR EUROPE AND BEYOND

One year after it started, MiFID II is having a material impact on the sell-side, buy-side, and IR professionals.

BY J.T. FARLEY

Clocking in at more than 7,000 pages (or five copies of *War and Peace*), the Brussels-born Markets in Financial Instruments Directive II (MiFID II) came into force in the European Union on January 3, 2018, promising to transform European capital markets and threatening to create ripple effects worldwide for institutional investors and brokers. One year later, MiFID II has proven to be more evolutionary than revolutionary, but the changes are still underway, and they are having a material impact on the relationship between the sell-side and the buy-side, as well as corporate issuers seeking to interact with both sides.

Breaking the Bundle

The aspect of MiFID II which is the most relevant to investor relations professionals is the requirement to unbundle research from trade execution. At a high level, most European asset managers, as well as asset managers outside Europe who manage funds for European investors, can no longer pass along to their investors the "bundled" cost of research and other services, such as corporate access, which MIFID II classifies as "inducements", combined with trading commissions.

Buy-side firms must pay separately for trading and then they can either choose to pay for research and other services out of their own pocket (so-called "hard dollar" payments), or they can pass along separate research charges to their investors through a mechanism known as a research payment account, or RPA.

The RPA method requires buy-side firms to set research budgets in advance in consultation their clients and then to meticulously document

all the costs of research, a level of transparency (and bureaucracy) which was unheard of before MiFID II. Given these requirements, many of the largest European money managers have chosen to pay for research with hard dollars, while smaller firms, including many hedge funds, have chosen to use RPA solutions and pass along the cost of research to their investor clients.

The unbundling requirements of MiFID II have taken a toll on the sell-side: average European brokerage commissions in the third quarter of 2018 were down approximately 30 percent year-over-year, according to analysis done by my firm, ITG.

While part of this commission drop reflects the unbundling of cash payments being made to research providers, overall spending on research is also dropping.

"The commission pool is shrinking and there is less overall being spent on research given the decision of most asset managers to pay for research out of pocket," says Tim Cave, a market structure analyst with consultancy Tabb Group.

A November 2018 report by Greenwich Associates bears this out, estimating that European research spending has declined 14 percent overall, with budgets at the largest asset management firms dropping 19 percent year-over-year. The average number of research providers used by institutional investors has also continued a multi-year decline, from 20 in mid-2015 down to less than 16 in 2018, according to Greenwich.

The shrinking research budgets and smaller execution commission pool have tilted the playing field in favor of the bigger investment banks. Some banks have been aggressive in setting initial prices for unbundled research access, such as J.P. Morgan, which offers firmwide access to PDFs of research reports for as little as $10,000 per year. (Access to financial models, and to the analysts themselves, carries a much higher price tag.)

"MiFID II has reinforced the dominance of the bulge bracket firms which have invested heavily in both execution and research," Cave notes. "This has had a knock-on effect for smaller research providers who may find it uneconomic to stay in business." He expects the decline in the revenue pool to accelerate the shakeout among equity research providers in the coming months.

There have already been signs of consolidation, with Alliance Bernstein agreeing to buy Autonomous Research, a UK-based financial services research broker, in November 2018, and media reports indicating that several other small brokerages in Europe are potential acquisition targets.

On the buy-side, unbundling results in comparatively deeper pockets for firms that opt to pass along the cost of research to their clients via RPAs. "The majority of European hedge funds are paying for research with client funds, unlike long-only funds, so they have more money to spend," observes Sandy Bragg, a principal at Integrity Research, an equity research consultancy.

Thinking Small

As most institutional investors have tightened their research purse strings and started to pare back on the number of their brokerage relationships, some smaller corporate issuers are finding they must work harder to get in front of investors in Europe.

"There has been an impact on smaller market cap sizes," says Charles Moreau, co-head of corporate access at Oppenheimer & Company. "Buy-side firms are applying greater scrutiny to the meetings they take and are less likely to take a meeting where they might have less familiarity with a stock, or if it is outside of their core focus. For larger-cap companies, it can be easier to book meetings given that many [buyside] accounts now have a rate card for such meetings, and therefore know how much they will have to compensate the sell-side for organizing it."

Moreau notes that, even with these constraints, investor relations professionals can still work to be heard by getting involved in investor targeting and partnering with corporate access professionals.

"If a company management wants to see certain investors, clearly communicating about targets and maintaining an active dialogue with the sell-side is important," he says. "We see the corporate access process as more collaborative than ever."

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Pay for Play

While the equity research wallet in Europe overall is shrinking, corporate-sponsored research reports are increasing in popularity, with full-service brokerages such as Kepler Cheuvreux, Oddo BHF, and Nordea Bank joining established sponsored-research providers such as Edison Investment Research and Hardman & Company.

These firms generally charge corporations a five-figure annual sum for research coverage of their stock, and normally provide the reports free on their websites for all investors so that they do not have to charge the buy-side to access them under MiFID II regulations. While these services are attractive to issuers that have seen their research coverage decline (or be discontinued altogether), it is not clear when corporate-sponsored equity research reports will gain broad acceptance among institutional investors.

View from the United States

While MiFID II has had an immediate and direct impact on the capital markets in Europe, the effects in the United States have so far been muted, with most firms choosing to "ring fence" their unbundling, limiting it to their investment vehicles that are directly subject to the MiFID II rules.

Still, most on the U.S. buy-side are expecting an impact: 87 percent of firms surveyed by Tabb Group in mid-2018 said they expect the rules to have either a direct or indirect impact on them, up from 68 percent in a survey conducted two years earlier.

"I think unbundling will be the norm, as it's something the end clients – asset owners – like, and the buy-side wants a global approach to paying for research," says Cave at Tabb Group.

However, there is some debate about how widespread unbundling will become. Integrity Research's Bragg sees a more gradual process unfolding.

"We're on a path toward unbundling but it's being driven largely by market forces and new technology," he explains. "The SEC has shown no interest in pushing for an elimination of soft dollar payments, which would require an Act of Congress."

Bragg believes adoption in the United States comes down to how aggressively asset owners will push for unbundling. But whether or not MiFID II unbundling is widely adopted in the United States, the equity research landscape is going to change.

While the jury is still out on how widespread unbundling will be in jurisdictions where it is not required, research firms are likely going to face shrinking client budgets, while consolidation is increasing on the sell-side and among active investment managers.

"The pressures on equity research are relentless, so investor relations professionals will have to take more ownership," Bragg notes. "That pressure is not going to go away as it is a function of larger market forces irrespective of what the SEC does or doesn't do — technology, the rise of passive management, declining commission rates, and increasing automation in the investment and trading process."

For his part, Oppenheimer's Moreau believes that investor relations professionals will continue to rely on firms which remain committed to the equity research business, as those firms will continue to have deeper buy-side relationships.

"Firms that provide research on the corporate story will do a more complete job of filling a roadshow day than those that do not," he predicts. "Having research capabilities is, for us, an important component to helping educate the buy-side and building overall awareness of the story. We find this depth of knowledge helps facilitate greater meeting conversion."

While the jury is still out on how widespread unbundling will be in jurisdictions where it is not required, research firms are likely going to face shrinking client budgets, while consolidation is increasing on the sell-side and among active investment managers. These trends will pose significant challenges for investor relations professionals as they vie for attention — and investment dollars — in an evolving marketplace. IR

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