Girding for New EU Capital Market Rules

Rule changes in Brussels could impact IRO relationships with analysts and investors.

By J.T. Farley

If you don't work in the capital markets sector, chances are you have never heard of a pending set of European rules with an unwieldy name: the Markets in Financial Instruments Directive II, or MiFID II for short. According the European Securities and Markets Authority (ESMA), the pan-European agency overseeing capital markets, MiFID II intends to "improve the functioning of financial markets making them more efficient, resilient, and transparent." These rules were originally set to go into force in January 2017, but due to delays in the labyrinthine drafting and approval process, they will now take effect one year later in January 2018.

Why should investor relations officers, particularly those outside of Europe, care about MiFID II? Among the many rules are two key provisions which will impact corporate issuers: First, a requirement that asset managers separate the payment of investment research from the payment of trading commissions, a practice known as "unbundling"; and second, rules which could prevent, or at least significantly hinder brokers from explicitly collecting

trading commissions to pay for corporate access (i.e., meetings between asset managers and company executives).

Not Just Europe

These rule changes may seem minor, but they could have repercussions well beyond the relationship between European asset managers and the brokerages who serve them. "This is not just a European event, it is something which doesn't require massive change to have significant impact given the generally low margins of the equity research business," says John Colon, managing director at Greenwich Associates, a financial services advisory firm. Colon notes that 30 percent of asset managers globally account for 70 percent of total commissions paid, and so these firms are likely to react to the new European rules in a way that changes the research landscape beyond the European Union. "These large, sophisticated firms are likely to pursue globally consistent practices, so there is likely to be impact in other markets, including the U.S."

Research Impact

Traditionally, full-service brokers such as large investment banks, charge their institutional clients for trading services and then "bundle" the cost of equity research into that price. The price paid depends on either the volume or the value of the shares traded. Under the MiFID II rules, such bundling will not be permitted. While the rules have not yet been finalized, it appears that asset managers will have to make separate payments for trading services and equity research. While asset managers will still be able to charge their clients for both trading and equity research, they will have to unbundle the payments and designate how much will be used for trading and how much will be used for research.

Many asset managers do some form of this unbundling now through mechanisms called Commission Sharing Agreements, or CSAs. (Disclosure: My firm, ITG, is an equity brokerage that also provides CSA services). However, under MiFID II, asset managers will be required to unbundle all of their commissions and they will also be required to define research budgets in advance as opposed to the current volume-driven method used to pay brokers. "Asset managers will probably have to be more discerning in how they choose research providers since they will have to go to their end clients to get them to agree to how much they will spend on research," says Anish Puaar, European market structure analyst at Rosenblatt Securities. Puaar notes that larger brokers may also be choosier about their clients. "Some major banks will likely adopt a more tiered approach, providing equity research to their clients depending on how much they pay, so smaller buy-side firms will have to look elsewhere for their research."

Overall, this budgeting requirement could give brokers less financial incentive to broaden their research coverage. "If commission volumes dramatically increase, the budgeting process will act as a ceiling on research payments to brokers," says Sanford Bragg, president of Integrity Research, a consultancy focused on investment research. "Budgeting will probably tend to dampen growth in the research market in the longer term," he adds. While Bragg considers the MiFID II rules "more evolutionary than revolutionary," he notes that requiring European asset managers to separate out research payments from trading will likely result in them paring back the number of trading relationships they maintain. This could, in turn, have a negative impact on the amount of equity research provided by mid-tier and regional banks.

Although mid-tier research providers and smaller asset managers could feel the squeeze, and smaller capitalization companies may see less equity research coverage, Rosenblatt's Puaar thinks the rules could prove to be a boon for independent research providers. "Investment banks have always provided research as a bundled service, so it's tough for them to put a price on it, while independent firms price research on their own. We're already seeing new technology platforms that aggregate this

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independent research and offer easier access for asset managers. But it remains to be seen how much and how quickly additional independent research firms will step up to the plate," he said.

Corporate Access Impact

The final MiFID II provisions on payment for corporate access are still somewhat unclear, but most observers expect that the U.K. Financial Conduct Authority's ban on using commissions to pay for corporate access will remain intact. On paper, that rule has had a significant impact – Greenwich's Colon notes that U.K. asset managers now report allocating less than 5 percent of their commissions for corporate access, down from over 20 percent before the rule change. Despite that, many brokerages in the U.K. continue to provide corporate access, particularly arranging meetings between large-capitalization companies and larger asset managers, often with only a modest direct non-commission payment (so-called "hard dollars") from their clients for this service. Colon notes that larger brokerages tend to view their relationships in terms of holistic "client wallets," so even under MiFID II, they are likely to provide corporate access for larger institutional clients who generate a lot of revenue overall without an explicit quid pro quo, but smaller institutions may find their access reduced.

Similarly, banks think holistically about the "wallet" of their corporate clients and provide a richer array of services, including research coverage and corporate access, to those larger or growth companies that are more active in financing, M&A, and transaction services as well as companies that are of greater interest to asset managers. Smaller companies, whether they are based in Europe or elsewhere, are likely to have a tougher time in Europe with the bulge-bracket firms under MiFID II, in Colon's view.

While the new rules could prove a hindrance to smaller cap companies in terms of attracting equity research coverage, Rosenblatt's Puaar suggests that these same companies could actually find themselves more in demand on the road. "Corporate access could be much more important to asset managers in a world with less research coverage for each individual company." It is possible that new entrants to the market will attempt to fill any gap left by brokerages in providing corporate access for small and mid-cap companies. "Technology will have an impact on corporate access and tech firms will make inroads on the investment banks, but it is a slow process to build up the critical mass to where it is convenient for both sides [asset managers and corporate issuers]," says Integrity's Bragg.

Navigating Unbundling

While MiFID II is not coming fast, it is definitely coming and will probably resonate far beyond the shores of Europe. Sixty percent of large U.S. asset managers surveyed by Greenwich Associates believe that it is somewhat, or very likely, that global markets will all be unbundled within the next five years. If you work for a smaller capitalization company likely to be most impacted by this shifting landscape, the good news is that many of the prescriptions for handling the changes come straight from your IR best practices playbook: cultivate a broader range of analyst relationships, do investor targeting to complement the efforts of your corporate access providers, and look into new independent research and corporate access services.

And keep an eye on Brussels. IRU

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