MiFID II Turns Two

Second Thoughts and Unintended Consequences

MiFID rules about unbundled equity research are still playing out in European and U.S. markets, sometimes in unexpected ways. Sponsored research is on the rise and NIRI has issued guidelines about using it.

BY J.T. FARLEY

It has been just over two years since the advent of the sweeping European Union financial regulations known as Markets in Financial Instruments Directive II (or MiFID II, for short), which took effect in January 2018.

The goal of MiFID II was to standardize practices across European financial markets and increase transparency and improve protections for investors.

The aspects of MiFID II most germane to investor relations professionals are the requirement to unbundle research payments from trade execution (which shrinks commission wallets, and thus likely reduces the number of sell-side relationships a particular investor has), and the prohibition on asset managers receiving valuable "inducements" (including most traditional research and corporate access) to encourage them to trade with a particular broker or investment bank.

These changes directly impacted European capital markets, but they have also had indirect impact in the United States.

As is often the case with sweeping pieces of legislation or financial regulation, the implementation of MiFID II has wrought some unintended consequences, even though it has only been in force for two years.

These consequences – namely, exacerbating the decline in brokerage commissions and increased pressure on many equity research providers – prompted the AMF (the French securities regulator) to propose a raft of changes to encourage research production and to bolster the health of smaller research providers and asset managers.

A Regulatory Rethink

"There has been a massive change to the equity research landscape, and not all the European regulators were on board," notes Anish Puaar, Market Structure Analyst, Europe, at Rosenblatt Securities in London.

The United Kingdom's Financial Conduct Authority (FCA) has been effusive in its praise of MiFID II, noting in a review of the rules that asset management firms "have improved their accountability and scrutiny of both research and execution costs, including where firms have chosen to charge research costs to clients."

The FCA notes that there has been little change in the amount of research coverage of U.K. companies while estimating that investors in U.K. equity funds alone could save a collective $1.2 billion in research costs over the span of five years.

One key part in these estimated savings is aggressive pricing of equity research by some larger investment banks, with some bulge-bracket firms offering full access annually to published research for as little as $10,000. This pricing has made it a more challenging market for smaller research providers with less diversified revenue streams as they compete for a piece of commission wallets which are shrinking at most asset managers.

While the FCA has expressed satisfaction with the impacts of MiFID II, Puaar notes that both the French and German regulators have been less keen than their U.K counterparts on how the regulations impacted the marketplace, as the rules have put pressure on both research providers and smaller asset managers.

These regulators are calling for a review of MiFID II unbundling rules, and potential changes could include exemptions for independent research providers, extended trial periods for research products on a per-asset-class basis, encouragement of sponsored (corporate issuer-paid) research, and allowing smaller research providers to be paid on a bundled basis.

These recommendations have fed into a broader European Commission consultation with the industry on potential amendments to MiFID II, which will likely be followed by proposed regulatory amendments sometime in late 2020 or (more likely) 2021.

NIRI Guidelines Regarding Company-Sponsored Research

The following guidelines were approved by the NIRI Board of Directors in March 2020. The document is available at www.niri.org/NIRI/media/NIRI-Resources/NIRI-Company-Sponsored-Research-Guidelines-final.pdf. These guidelines supplement the "Best Practice Guidelines Governing Analyst/Corporate Issuer Relations" (2004), which were prepared by the CFA Institute and NIRI, and are available at www.niri.org/NIRI/media/NIRI/Advocacy/CFAINIRIGuidelines.pdf.

With the advent of MiFID II, sell-side analyst coverage for many EU issuers has dropped significantly. Sell-side coverage has also declined in the United States.

As MiFID II, commission compression, and other technical and structural changes press asset managers and brokers to unbundle research costs, there is a growing likelihood that more listed companies, most notably micro-, small-, and mid-cap issuers, may lose sell-side coverage. The loss of such coverage, especially for smaller issuers, creates a disadvantage in the capital marketplace and reduces the visibility of such companies to investors.

As a result, public companies (issuers) may decide to pay for research from third-party firms.

NIRI provides the following guidelines to assist companies considering commissioning such research:

1. Issuers should engage only research firms that have adopted written ethical standards that address analyst independence and how the research firm mitigates conflicts of interest.
2. Issuers should engage only research firms that agree to produce objective and thorough research reports that fully disclose any matters that could reasonably be expected to impair their objectivity.
3. Research firms should act as "arms-length" outsiders, working with material information that is publicly available.
4. Issuers should compensate the research firm in cash – not in stock or stock warrants.
5. Issuers shall not provide any compensation to the research firm that is contingent on the content or conclusions of the research (or the resulting impact on the issuer's share price).
6. Issuers should not attempt to explicitly or implicitly influence the research, recommendations, or behavior of the research firm analysts who are preparing the sponsored research.

The cover page of the commissioned research report (and any updates) should:

1. Clearly indicate the name of the issuer that commissioned the report.
2. Confirm that all compensation received by the research firm from the issuer for said research was in cash, not stock (or stock warrants).
3. Prominently display the name and contact information of the research firm.

In addition, the research firm should provide the following information in the "Disclosures" section or at the end of the commissioned report (or any updates):

1. The nature and extent of any personal, professional, or financial relationship the research firm or its parent, subsidiaries, agents, or trading entities has with the issuer, its personnel, parent, subsidiaries, or agents.
2. Any other matters that could reasonably be expected to impair the research firm's objectivity in drafting the report.
3. Disclosure of any agreement, condition, or limit on the ability of the research firm to trade in the stock of the issuer covered by the report.
4. A summary of the research firm's standards and policies to ensure editorial independence (e.g., analyst independence is enforced by research fees set (or paid) in advance; analysts have full discretion on price targets.)
5. The research analysts' credentials, including professional designations and experience, that qualifies them to produce the report.
6. Whether the report is a one-time publication or if the research firm will provide continuing coverage. If the research firm plans to provide ongoing coverage, it should disclose how to obtain updates.
7. The research firm's distribution methods and channels for sponsored research.
8. The research firm's rating system and distribution of ratings among issuers paying for research coverage.

Questions about the ethics of engaging in sponsored research can be addressed to the Chair of the NIRI Ethics Council. **For more information, visit www.niri.org/about-niri/ethics-council.aspx.**

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- Sandy Bragg, Principal, Integrity Research Associates

U.S. Impact

Due to the global nature of financial markets, MiFID II has also had an impact on institutional investors, brokers, and corporate issuers far beyond the shores of Europe, albeit a more limited one.

"As unbundling played out in Europe it was, to a large extent, traditional long-only managers choosing to pay for research out of pocket," says Sandy Bragg, Principal at Integrity Research Associates, a consultancy that tracks the investment management industry. "One year ago it seemed like there was a similar movement by U.S. asset managers to decide to pay for research out of their own P&Ls, but after a handful of managers made that move, very few really followed suit."

Bragg notes, however, that one aspect of MiFID II is having a lasting impact in the U.S.: unbundling. "The separation of execution payments from research payments can be done while still passing along research costs to asset owners, and that form of unbundling has definitely expanded in the U.S.," he explains.

While initially driven by MiFID II, Bragg believes this itemization of research and execution fees has also been motivated by asset managers seeking to get a handle on costs and to compete more effectively with passive investment managers.

Bragg also believes that there is little appetite for a transatlantic harmonization of unbundling rules. "The SEC has been hostile to the idea of MiFID II. They extended a 'no action' letter at the request of investment banks who wanted to be able to accept cash payments for research without having to become registered investment advisors, but otherwise the Commission hasn't been accommodating to the European regulations."

Further muddying the regulatory landscape is the U.K.'s exit from the European Union, currently in process. "Once the U.K. leaves it could maintain the MiFID II rules or draft its own, whereas the European Union looks likely to relax the current rules," Puaar notes. "The prospect of managing three different research regimes for the U.K., the EU and the U.S. would be a very difficult thing for institutional investors."

As regulators consider how to reshape MiFID II, two aspects of the capital markets have been changed significantly by the rules: corporate access and sponsored research.

Corporate Access

While in the U.K. the FCA's interpretation of MiFID II is that asset managers cannot be provided with free corporate access, the AMF in France has a more relaxed stance, considering it to be a "minor non-monetary benefit" and hence acceptable under the regulatory regime.

In the United States there are no MiFID-like restrictions on corporate access, but declining research commission wallets, exacerbated in part by unbundling, have prompted some changes.

"MiFID II has moved some asset managers to be more proactive in hiring dedicated corporate access staff, and it has fostered more direct interaction between the buy side and corporations," Bragg observes. "Many brokers are focused on more value-added corporate access such as reverse roadshows or other high-touch forms of access for which they can still expect to be paid."

He also notes that the COVID-19 pandemic has further changed the corporate access landscape, given the sudden shift to virtual meetings and roadshows. For his part, Puaar thinks we could see a reversion to traditional corporate access, post-pandemic: "video conferencing and investor calls are definitely a good idea, but a lot of investors thrive on face-to-face contact, especially with small and medium-sized issuers."

Sponsored Research

MiFID II has also presented an opportunity for providers of sponsored research, as they are able to give their reports to everyone on the buy side for free, unlike their traditional sell-side counterparts.

While sponsored research has long been the norm in credit markets (where issuers typically pay for bond ratings), it has been slower to catch on among equity investors. It is more popular in Europe, where several Nordic banks and France's Kepler Cheuvreux have joined sponsored-only research providers such as Edison and Hardman in providing the service.

In the U.S., sponsored research was once largely

confined to microcap stocks. However, given the decline in overall coverage of small- and even mid-cap companies, there has been an increase in the offerings available, with well-regarded research firms such as small-cap specialist Sidoti & Company and consumer boutique Telsey Advisory Group offering sponsored research in addition to traditional sell-side coverage.

NIRI has taken a position on sponsored research and published the "NIRI Guidelines Regarding Company-Sponsored Research," shown in the sidebar on page 33.

More Impacts Ahead?

While MiFID II has spurred significant changes in the relationships between asset managers, brokers and corporate issuers, the landscape continues to evolve. Commission wallets have declined steadily – in the United States, Greenwich Associates estimated that equity commissions paid by U.S. institutional investors fell by nearly half from 2016 through early 2019, and by 2019 nearly 60 percent of commissions were unbundled, no longer tied to the research provision.

Integrity's Bragg does not see the picture becoming brighter anytime soon. "As we move into a bear market, the pressures on fees and commissions continue, but it is no longer regulatorily driven, it is market- and technology-driven," he says. "These pressures on research providers aren't going away."

This pressure has moved several firms to exit or dramatically scale back U.S equity research, including Deutsche Bank, Macquarie Group in 2019, and Buckingham Research Group, which shut its doors in March of this year.

Increasingly, to be viable in the long run, equity research providers need to have scale in execution and research, or strong domain expertise in particular sectors and the ability to provide truly differentiated content, or both.

Given this backdrop, investor relations practitioners need to be ever more aware of the economics driving both the buy side and the sell side as they interact with them. IR

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