

THE MiFID II EFFECT: RESEARCH IN FLUX

MiFID II regulations are now the law of the land across Europe, sparking change in the sell-side research business as banks and brokerages forge fee-based research models.

BY AL RICKARD, CAE

When the Markets in Financial Instruments Directive (MiFID) II regulations took effect in Europe on January 3, 2018, it signaled a global shift in how equity research will be handled.

While European investment banks move aggressively to unbundle trading commissions and research fees to comply with the new rules, the global nature of trading means that banks and brokerages everywhere are also moving toward this new model.

So what will research look like going forward? Will banks sell their research a la carte? To what extent will buy-side fund managers pay a fee for research? What price points will the market bear?

Will some mid-cap and small-cap companies be forced

to pay for their own research to generate adequate analyst coverage of their firms?

A shakeout in the volume of sell-side research has been underway for some time, with MiFID II accelerating the trend. If this means the number of analysts covering the most popular large-cap companies goes from 40 to 20, that's likely not a problem. But if a mid-cap or small-cap company covered by 4-5 analysts suddenly has only one analyst (or none) covering it, they need to look at new options – possibly including paying for research themselves.

An Uncertain Future

Faced with more questions than answers at this early juncture, no one claims to know how it will ultimately play out.

The Securities and Exchange Commission (SEC) recently resolved a conflict between European and U.S. rules regarding paid research when it announced a 30-month suspension of a provision of the Investment Advisers Act of 1940 that prohibits U.S. banks and brokerages from charging fees for research unless they register as investment advisors. This provided some clarification – at least for the short term – but uncertainty still remains.

Matt Lyons, CFA, senior vice president and global trading manager at the Capital Group, predicts that the transparency in research costs required under the new regulations “will cause a sea change in what investment clients think about research.” His buy-side firm manages \$1.5 trillion in assets.

Lyons offered this comment as part of a session called “The Creeping Role of MiFID II” at the recent NIRI Senior Roundtable, where Sam Levenson, CEO of Arbor Advisory Group, moderated a panel that also included Mark Pellegrino, managing director and head of the Market Solutions Group at Balyasny Asset Management; and J.T. Farley, managing director, investor relations and corporate communications at Investment Technology Group, Inc.

Describing the impact of MiFID II on the sell-side, Theo O’Neill, IRC, vice president of investor relations for Corbin Advisors offered his views recently in a NIRI Virtual Chapter webinar on *The Evolution of Sell-Side Research*: “It’s like being in a room blindfolded with an elephant and trying to describe what the elephant looks like.”

Drawing conclusions from the SEC action, he said, “European banks will extend their paid research model to the United States because of the SEC ruling; it is a lot easier to make research an unbundled paid product on a global basis. The fees will likely range from free to a couple hundred thousand dollars per year. But no one knows what research is worth because it has always been a cost center and not a revenue generator.”

Erosion of Sell-Side Research

As a former sell-side analyst and banker who cov-

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ered technology stocks for 25 years and worked on the buy side for four years, O’Neill has seen the long-term erosion in sell-side research firsthand. “Of the 10 investment banks I worked for, seven no longer exist,” he reports.

“MIFID II may well lead to further disparity between large cap and small cap companies,” Levenson noted at the NIRI Senior Roundtable session. “If you are a large or mega-cap company and have 40 analysts covering you, then a reduction to 20 may not be all that impactful. If you are a small-to-mid-cap company with three analysts and some or all of them go away, it is a real challenge. The onus will be on the IRO to drive a proactive IR program, delivering the right message to the right audience – and to do so without very little support from the banks.”

“The baseline expectation seems to be that research-related revenue will decline about 30 percent with a similar reduction in the head count,” adds Brendan Metrano, vice president of investor relations at DHI Group, who also spoke on the NIRI Virtual Chapter webinar. He moved from the sell side to an investor relations position in late 2016 after spending 10 years in equity research.

A study by Quinlan & Associates, a strategy consulting firm specializing in financial services, chronicled the continuing decline in sell-side research in its 2016 report, “Research in an Unbundled World,” which provides an outlook for sell-side research providers now that MiFID II is in place.

“It is widely recognized that investment managers are currently awash with an oversupply of duplicative research reports, much of which is considered of questionable value,” author Benjamin Quinlan, CEO and managing partner of Quinlan & Associates, writes in his introduction to the report. “We predict a decline in global research spend of up to 25-30 percent by 2020.” (In the same report Quinlan also noted that research budgets had already declined 20-25 percent from 2012-2016.)

Despite these forecasts, Metrano predicts that the impact will take a long time to play out. “Businesses are hesitant to change until they are forced to,” he notes, “and there is a huge sell-side research infrastructure in place, so banks will probably

innovate a little in pricing and how they market research. Eventually it will cull the herd, as there is definitely excess capacity in sell-side research.”

“We anticipate major disruptions to the competitive landscape,” Quinlan writes in his report. “Global investment banks will need to narrow their coverage universe, given the inability to monetize lower-value content. Tier-2 providers will find the new competitive environment even more challenging and may be forced out of the market altogether. However, given the low barriers to entry, we are likely to see a proliferation of independent research houses, led by one or more ‘star analysts’ specializing in particular sectors or geographies.”

Changing Research Buys from Asset Managers

Peter Molloy, CEO of Edison Investment Research – the largest player in the issuer-funded research market in Europe and one of the largest in the United States with 420 corporate clients – believes “fund managers will scrutinize the top three research houses” as they winnow down research sources for large-cap market coverage. “This will accelerate the pressure on research in the United States for small-cap and mid-cap companies. Banks and fund managers will allocate most of their budgets to large-cap research, so it will make it more challenging for small-cap companies to receive coverage.”

Quinlan pointed to certain independent research providers in his report such as Wolfe Research (covering utilities, transport and energy) and Zelman & Associates (covering housing and homebuilding) that have “made a notable mark in their chosen sectors” that they market to the buy side.

He predicts that “buy-side research budgets will increasingly evolve into specialized service pots, with fund managers choosing firms for their specific service niches: for example, Bank A for its political connections in China and Bank B for its access to deal flow.”

But while this model suggests that institutional investors will pay for sell-side research on a fee basis, there are limits to the volume of research

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business and the price points that the buy-side may be willing to pay.

Molloy explains, “Regulation is forcing and moving the purchase of research to fund managers, but our view is that banks have massively overestimated the willingness of fund managers to pay for research. It will be a big wakeup call for banks when fund managers are not paying. If funds paid the equivalent amount for research as they previously through commissions out of their P&Ls it would decimate their profit margins.”

Farley, speaking at the NIRI Senior Roundtable, believes that “large companies such as Schroders and T. Rowe Price will pay for research out of their P&L, but smaller companies can’t do that.”

O’Neill notes that some buy-side investors “indicated they are not going to pay for research and are going to hire people internally and do it that way. That is definitely going to happen for a lot of investment houses.” Lyons agrees this is the case.

A recently published survey called “MIFID II & Research” conducted by *Institutional Investor* magazine in collaboration with ONEaccess (A Visible Alpha Company), and Substantive Research found that 52 percent of fund managers (90 percent of those surveyed were from Europe) plan to pay for research from their P&Ls, while 29 percent plan to use research payment accounts (RPAs) – a mechanism created by MiFID II, 14 percent plan to charge clients, and 5 percent are not sure.

It is unclear whether U.S.-based asset managers will follow suit and at what level they will pay for research. What is more certain is that they will place a high value on ROI to justify external research spending they make in an unbundled environment where they will face increased scrutiny from investors. Duplication of research will be reduced and the buy side will put a higher premium on high-quality, differentiated research.

We value and pay for outside research providers; currently we receive research from over 420 providers,” Lyons says. “The ultimate objective is to produce superior results for our clients. Whatever we need to achieve that goal we will acquire. We are in an equilibrium discovery mode – we will get offers

and we will pay based on what we see the value is.”

Among the predominately European asset managers surveyed by *Institutional Investor*, 75 percent plan to reduce their external research budgets paid to investment banks under MiFID II – nearly half of them plan cuts of more than 20 percent. About half of fund managers (53 percent) plan overall reductions in their external research budgets. Meanwhile, 80 percent say their internal research budgets will stay the same and 20 percent say these will grow.

Issuer-Paid Research

So if banks cut back on much of their research and buy-side investors pay only limited amounts for external research, who will pay for the rest of the smaller-company research that nearly everyone in the capital markets sector agrees is needed? Some point to corporate stock issuers – especially mid-cap and small-cap companies – which lays the problem squarely at the feet of investor relations professionals.

“If you are a mid-cap or small-cap company, your life is going to get a lot harder,” Levenson told IROs at the NIRI Senior Roundtable.

“Most IROs are very reluctant to adapt to the change,” notes Peter Sidoti, founder of Sidoti & Company, LLC, an equity research firm focusing on small-cap companies. “It is hard to pay for something you have always gotten for free.”

“We may fight for airtime and coverage more than we did before because companies that previously used commissions to pay for research may fold up their tents and go home,” says Farley, whose company is only covered by three analysts but is not paying for research. “I hope it doesn’t come to that.”

While some point to the perception that research paid for by a company is inherently biased, Sidoti observes that in the United Kingdom, company-sponsored research is a well-accepted vehicle with hundreds of companies covered.

“Conflicts abound everywhere,” Sidoti admits, but he argues that if research companies come to be respected as “honest brokers,” investors will recognize that they provide credible securities

research. He draws an analogy to the debt markets, where debt-rating companies such as Moody’s Investors Service and S&P Global Ratings are paid by issuers to produce reports.

“Many are looking only at one side when criticizing paid research, which has a long positive track record and yet is criticized,” he adds. “Anyone who is involved in the securities research industry knows that it is rife with potential conflicts. Rules and regulations put in place by the Sarbanes-Oxley Act of 2002 (SOX) and the Financial Industry Regulatory Authority (FINRA) have mitigated – but clearly not eliminated – these conflicts. The cost of running a research department is enormous and most brokerages cannot afford to bear them unless the research leads to seven- or eight-figure investment banking fees.

“Nowhere has this dynamic had a greater impact than in the small-cap arena, where large banks have all but stopped offering coverage and smaller houses carefully consider whether an investment banking fee is on the horizon before they cover a company. Brokerages do earn sales and trading income from providing small-cap research, but given the influx of passively managed funds, lower trading volume and declining commissions, payments from active money managers cannot sufficiently subsidize their research efforts.”

New Research Company Models

New types of firms are emerging to serve the needs of the changing research market.

For example, OTC Markets Group, a New York-based company with a \$326 million market cap, launched its online “Research Marketplace” in 2016 to serve the needs of microcap companies that needed analyst coverage. It contracts with Sidoti, Edison, and ACF Equity Research to provide coverage to its clients and is considering a few additional research providers for potential inclusion in this carefully vetted group.

Jason Paltrowitz, executive vice president, corporate services at OTC, explains that in the rapidly changing research market, small-cap company CEOs who faced disappearing analyst coverage were often victimized by “bad actors,”



A SQUEEZE ON CORPORATE ACCESS

With the decline in sell-side research coverage comes a reduction in buy-side corporate access

through brokers, mostly for smaller companies. But corporate access is valued highly by the buy-side and issuers want exposure to asset managers.

“The vast majority of institutional investors are not going to make a purchase decision without having first met with the management team, and that is doubly true for smaller cap companies,” notes Sam Levenson, CEO of Arbor Advisory Group. “That said, if you are a smaller cap company, the days of phoning an analyst covering your company and asking them to set up a roadshow may soon be numbered. We believe that, in the post MiFID II world, there will have to be more direct interaction between issuers and investors without the banks acting as a liaison.”

An Ipreo Special Report, *MiFID II: A Check on Reality*, which surveyed 50 institutional investors, supports this view, noting, “With the expected increase of responsibilities falling onto the IR function, respondents expect companies to grow their IR teams in order to deal with an increased volume of requests and ensure that outreach remains unaffected.”

“Corporate access is being clearly separated from research,” says Peter Molloy, CEO of Edison Investment Research. “A lot of MiFID II is about not having any inducement tools, so investors will be more likely to speak with management directly or through an IR agency. We expect U.S. banks to find roadshows to be less profitable.”

The Ipreo report predicts, “Brokers may focus their activities around the most profitable events

for top-tier clients, leaving smaller stocks and/or less popular sectors with less coverage and

marketing. In response to these changes, there is an expectation that IR will need to undertake more of these activities themselves (both marketing and event execution).”

One European mutual fund investor commented in the Ipreo survey, “It is a new situation and a lot of work that is done by entire industries is falling back into

the IR department. IR teams will be swamped with requests. It would be poor corporate governance if companies are not prepared. Companies need to expand their IR teams to deal with MiFID II.”

John Dwyer, senior research analyst, Celent, who wrote a report titled, *From Corporate Access to Direct Access: The Implications of MiFID II on Corporate Access*, adds, “When regulatory change and technology meet a process, such as corporate access, which has friction and fundamental pain points, then business models and operational practices will transform.

“Corporate access has the potential to morph into something direct in nature and thus be characterized by much improved flow of information, data, communication, capital, and alpha. Given this potential the buy side, sell side, and corporate constituencies should get on board.”

Nevertheless, panelists at a session at the NIRI Senior Roundtable highlighted the fact that brokers are not going away and there is still value in having a relationship with the Street. And even though there may be fewer opportunities for roadshows, identifying the top sell-side thought leaders and going on the road with them can be a good strategy.

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prompting the launch of his firm to provide a credible alternative for issuer-paid research.

“There are hundreds and even thousands of research providers,” he observes, “and you have to peel back the onion on those providers to see who the good ones are.” Some criteria for quality providers include giving proper disclosures, understanding editorial guidelines, charging for research in advance (not after research is written), not making buy/sell recommendations, and not taking equity compensation.

OTC even pays two research companies itself to cover its own business. “We want to eat our own cooking and improve our reach to the buy-side,” Paltrowitz notes. His company has grown to a \$300 million market cap and he notes that the market ecosystem requires third-party coverage.

“These research providers talk to us, hear our story, look at our filings, and put all this in a format that the buy side is used to receiving,” Paltrowitz says. “Because of this, we have more exposure to the buy side than we ever had before. Fund managers call us and are joining our earnings calls. The research has opened up our company to investors that we never would have found on our own.”

Eric Langan, CEO of RCI Hospitality Holdings, Inc., a Houston based company with a market cap of more than \$300 million that trades on Nasdaq, says this about the research it pays Sidoti to conduct: “Our relationship is no different than what it would be with any brokerage firm analyst. The analyst has taken the time to learn about our company and visit our subsidiaries. The reports, estimates, and valuation have all been independently developed.”

Scott Powell, executive vice president and head of investor relations for VolitionRx Limited and chief financial officer at Volition America, explains that for his smaller public company (\$88 million market cap that trades on the NYSE American exchange), “paid-for research was a way for us to increase our analyst coverage and try to reach a wider institutional and retail investor audience. Issuer-paid research is not really biased in my experience and has become much more accepted by investors in recent years. Our paid research

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analysts ask us challenging, probing questions and produce very rigorous, thoughtful research.”

Exchange-Based Research?

In looking to the future, Sidoti points to the potential of the paid-research model used in the debt markets.

“Companies today pay Moodys, S&P, and Fitch to rate their debt,” he explains. While this rating system was criticized in the wake of the financial crisis nearly 10 years ago, it has since come to be regarded as a more credible and reliable rating system in this sector.

“We expect that these organizations or an agent (such as an independent IR firm, an exchange like Nasdaq, NYSE, or IEX) will now need to pay for equity research,” Sidoti adds. “But the product will need to come from a reliable source. That is the model used in European and Asian countries.

Molloy reports that his firm, Edison Research, is already working with four exchanges – Deutsche Borse, Singapore Exchange, Tel Aviv Stock Exchange, and the New Zealand Exchange – to provide research for small- and mid-cap companies.

“These and other exchanges recognize that they face a challenge if many of their listed companies lose coverage, so if the markets don’t have a solution they have to develop their own solutions. Otherwise they don’t really function well as a stock market.”

Sidoti sees solutions like this coming to the United States: “The good news is that Wall Street is amazingly resilient and new business models are likely to unfold. Management teams and investor relations professionals will need to adjust to new paradigms that will surely emerge, but we expect that as research providers, management teams, investor relations firms, and investors embrace these new models, the benefits each will derive will be significant.” 

AL RICKARD, CAE, is president of Association Vision, the company that produces *IR Update* for NIRI.