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WHO'S AFRAID OF MiFID II?

With European regulators writing the rules for global capital markets and foreign too-big-to-fail banks egging them on, what could possibly go wrong?

Requiring seven years to draft and weighing in (currently) at 1.4 million paragraphs of rules and regulations, MiFID II, is a revamped version of the Markets in Financial Instruments Directive. Consider yourself lucky if you ply your trade in the investment business and you've never heard of it. Putatively created to offer greater investor protection and market transparency, a cynic might view it as the latest attempt by the European Parliament, European Commission and Council of the European Union to "reform" the capital markets. The directive will affect virtually every bank, mutual find, exchange, broker, pension fund, retail investor and high frequency trader that does business in Europe. Clearly experts on building robust banking systems and deep capital markets, the European Union's social engineers will try to regulate virtually every aspect of the financial markets, covering everything from maintaining taped conversations of securities orders to regulatory filings for transactions that can stretch to more than 65 separate fields.[*]

For the purposes of this essay, we'll focus on the most controversial aspects of the law - the unbundling of the costs of research from trading and "best execution." I will stipulate at the outset that I am not writing about this subject as a disinterested party. I would further admit that if one were to think about creating a capital markets system from scratch that using client commissions to pay for investment research might not be the most obvious way to allocate scarce resources. Still, I have yet to hear of a better alternative and I am convinced that the changes to the system proposed by MiFID II will aid neither the end consumer of investment management nor the formation of capital. Small issuers will find it difficult to find investment banks to cover them and, as an analyst from Cowen noted earlier in the week, could do serious damage to America's IPO market. In extremis, the law could also greatly harm one of America's most envied and globally competitive industries – financial services.

My experience as a financial professional and as an entrepreneur has revealed a central irony of the attempts of unelected regulators and opportunistic politicians to save the rest of us from ourselves – large government "solutions" almost always have the unintended effect of disproportionately benefitting large public companies. After all, they are the ones who have the lobbyists, lawyers, consultants, accountants, and political action

[*] What is Mifid II and how will it affect EU's financial industry? *The Financial Times*, September 15, 2017.

committees that often give them bespoke tax and regulatory treatment. It is the reason the U.S. tax code is now 3.5 million words (the Old and New Testaments combined have a little less than 800,000).

No one could dispute the fact that, in the old days, there were some unscrupulous investment managers (and brokers who serviced them) who would conspire to use client commissions to pay for business expenses, like office space and lunch, that should have been borne by the firm's partners themselves. Good research, on the other hand, is an integral part of the investment process, theoretically the life's blood of prudent investment decisions and risk-taking. As near as I can tell, the biggest proponents of unbundling fall into two categories: 1) those who mistrust the financial services industry so much that they wish to impose a solution to something very few people actually see as a problem; and 2) large buy and sell side financial services companies who see this as an opportunity to put smaller competitors out of business. In a recent article in *The New York Times,* a financial columnist suggested that unbundling would "encourage the creation of high-quality independent research shops" at which point I said "BWAAHHAHA." I am uncertain how many independent research providers the author knows but doubt seriously whether she bothered to consult one in the course of her "reporting." If she talked to us, we would have asked her to consider a simple syllogistic question – can something that hurts a company's clients be good for the company itself?

Aside from the fourth estate, there are others in the business itself who are seeking to use a law comprised of nearly 171,000 words as a form of marketing or to engage in predatory business practices to drive competitors out of business. Companies like Credit Suisse and ING have come up with a creative way of avoiding the claim that they are providing inducements (a.k.a. bribes) for money managers to direct trades to them – they're going to make some of their research publicly available *for free*. What logical explanation could there be for large companies incurring hundreds of millions of dollars in operating expenses to provide a research product to suddenly decide to give it away? In what business would that not be considered anticompetitive? Little by little, Big Tech has reminded us of one of the first lessons we are taught in economics – there truly is no free lunch. Beware the businessman who offers to give you something for free.

But who cares, really, about brokers and their alleged cupidity? What of the investment management industry itself? Here again, a number of high profile buy side shops have taken great pride in beating their breasts in generously offering to pay for their research costs out of their own P&L. Of course, the companies so generously "offering" to do this on behalf of the client are large and well capitalized enough to afford it. Smaller investment managers would find themselves unable to bear the costs or their ability to do the hard business of investment research economically would be so impaired that many would either be forced to sell their assets to larger players or cease operations altogether.

As with most regulatory reforms, the plight of the little guy who doesn't have a seat at the table seems scarcely to have been considered.

As a small firm and a macro shop, we have, mercifully, not had to endure the burden of time and cost other far larger brokers have had to deal with in preparation for the new rule. So far, we have received only one RFP that asked how we might price access to everything from our written research alone, to one-on-one analyst meetings, special research projects, our conference calls, admission to our conferences, and meetings with corporate management in a post MiFID II world. After two soul-sucking hours, our management team, consisting largely of economists, concluded that it is virtually impossible to price the marginal cost of a service designed to help other people think. We replied that, if required, we would make a determination about pricing as close to the point of sale as possible according the laws of supply and demand. As luck would have it, the rule is coming on top of the fact that street research has been buffeted by all-time high notional prices of stocks. For a business paid on a cents per share basis, the difference in commissions paid to the Street should, assuming the notional dollars invested remains the same, be 60% less during a period in which the average stock price is $100 per share as compared to a period when the average stock price is $40 per share.

In what must be considered a final irony, it is currently illegal for American broker-dealers to unbundle research from trading. Getting an earful from the financial services industry, this week the SEC issued what is called Non-Action Exemptive Relief from the rule. This means that U.S. brokers with operations in Europe can be paid for research in a bundled capacity in the lower 48 and still comply with MiFID on the Continent. This has provided some comfort to American brokers but one wonders whether, once a precedent has been set, the SEC's decision will provide any relief at all to small money managers and brokers. It all reminds me of William Graham Sumner's definition of the "forgotten man:"

"As soon as A observes something which seems to him wrong, from which X is suffering, A talks it over with B, and A and B then propose to get a law passed to remedy the evil and help X. Their law always proposes to determine what C shall do for X, or, in better case, what A, B, and C shall do for X... What I want to do is to look up C. I want to show you what manner of man he is. I call him the Forgotten Man. perhaps the appellation is not strictly correct. He is the man who never is thought of.... I call him the forgotten man... He works, he votes, generally he prays—but he always pays..."

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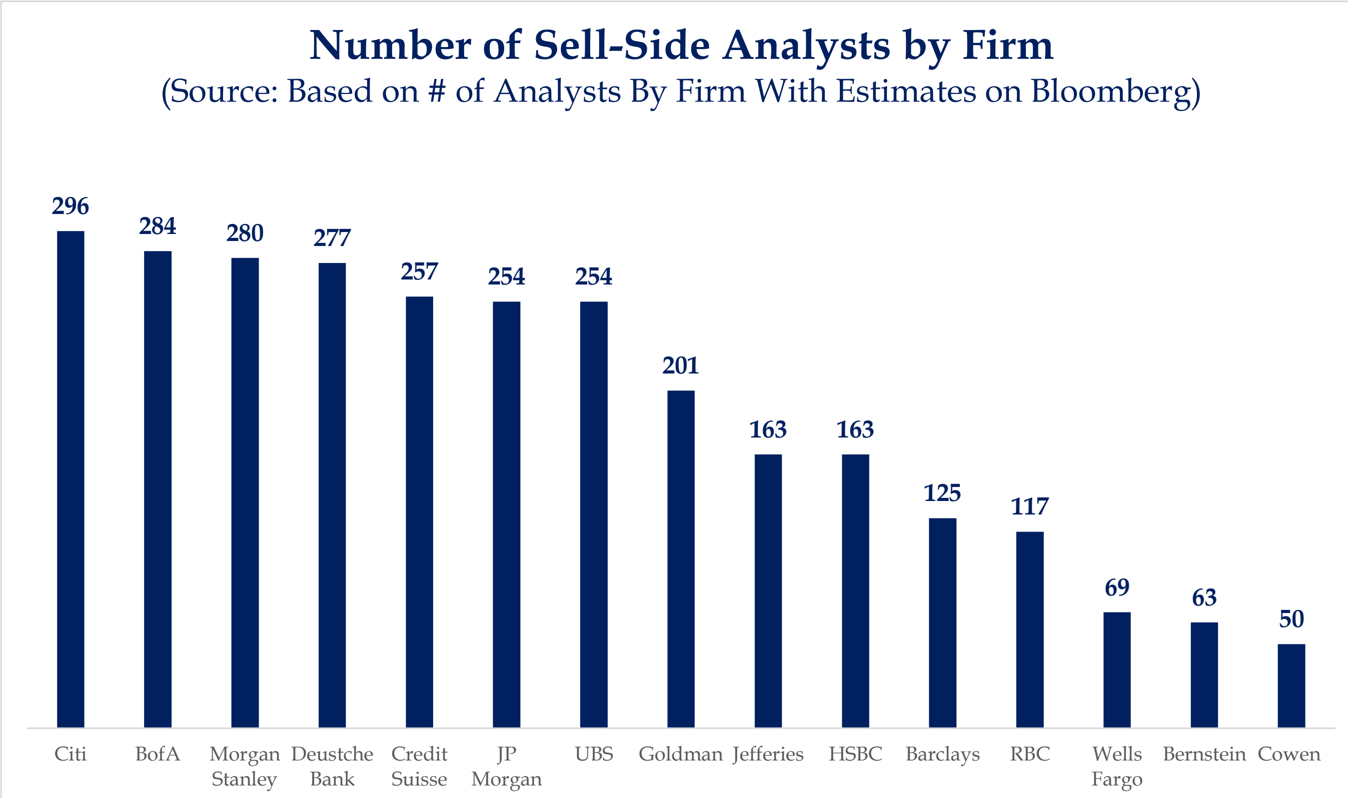
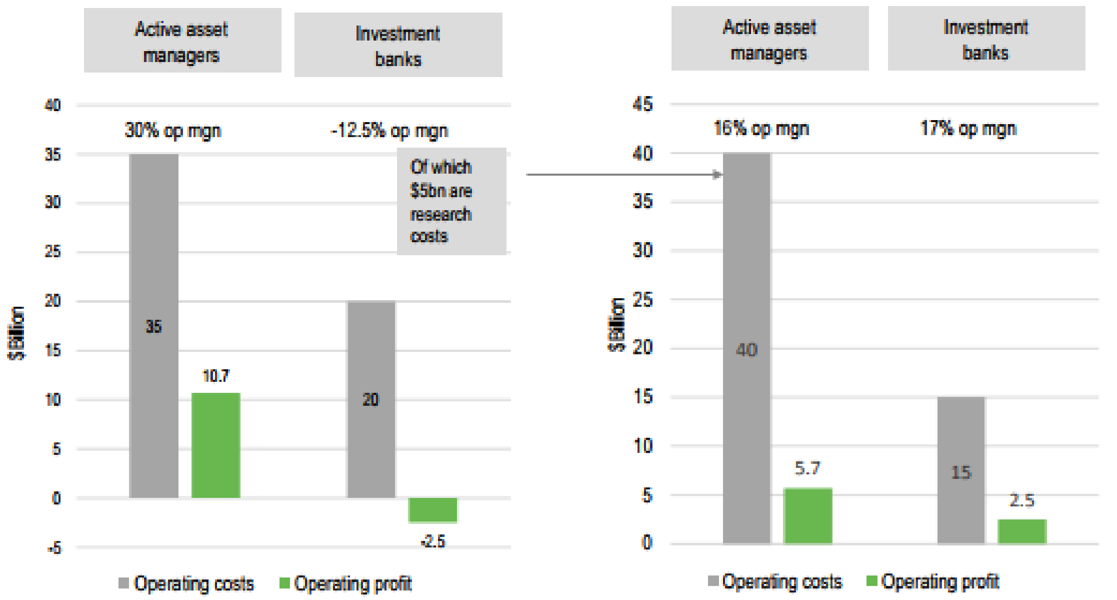


MiFID II Versus Dodd-Frank

	MiFID II	Dodd-Frank Act
Number of Words	The 2014 Directive and Regulation are a combined 115,465 words. 2016 supplementals are a combined 66,803 words. The 28 technical standards in the OJ are combined nearly 171,000 words.	396,348 words in the statute. An estimated 28 million words in related rulemaking.
Number of Pages	The 2014 Directive and Regulation are a combined 213 pages. 2016 Supplementals are a combined 145 pages. The 28 technical standards published in the OJ equate to 400 pages. The European Securities Markets Authority has published thousands of additional pages, for instance the Technical standards are 553 pages.	The final Dodd-Frank Act was 849 pages (versus 2,319 drafted). As of July 2017, 26,430 pages of related rulemaking have been published.
Number of Regulations	28 technical standards	390 regulations with 280 finalized as of July 2017.

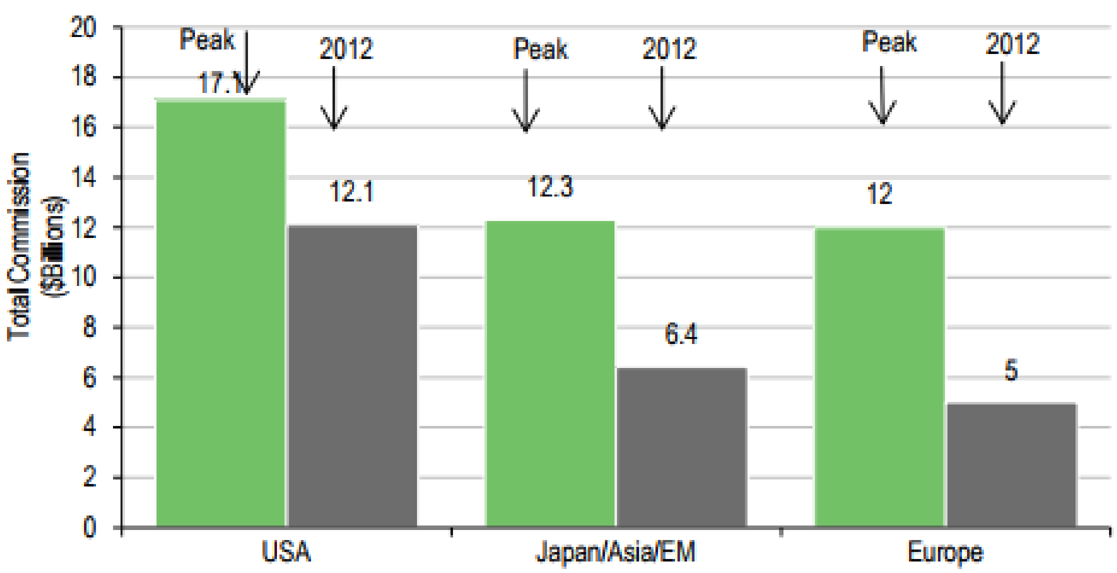
Sources: Davis Polk & Wardwell LLP, GPO, ESMA, Norton Rose Fulbright, Official Journal of the European Union (OJ)

Exhibit 1: Asset managers' margins would halve if they absorbed the cost of investment bank research



Source: Frost Consulting estimates

Exhibit 4: 43% decline from peak to 2012 in equity commission payments



Source: Frost Consulting