MELIUS RESEARCH

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A Year Into MiFID II

By Scott Davis & Carter Copeland

Why MiFID II Isn't Working as Intended and Investors are Losing as a Result

When we launched Melius Research as an independent research and data analytics platform just over a year ago, our stated aim was to become a trusted partner for buy-side money managers who favor seasoned and knowledgeable analysts, independence, and customized service. Our view was, and continues to be, that alpha generation can be maximized by combining unique and newly available data sources with traditional fundamental research. And we believe that as an independent firm we can more easily and rapidly explore these opportunities purely for the benefit of our clients.

It is by coincidence that the launch of Melius briefly preceded the adoption of the MiFID II regulatory framework in January of this year. MiFID II is a massive set of rules put in place by the EU aimed at increasing transparency and decreasing systemic market risks identified in the Financial Crisis of 2008-2009. The transparency-oriented angle of the regulation is specifically aimed at educating and protecting investors, and in many respects should support the view that research and data services will have to increase in quality over time to justify what investors pay for them. However, we think poor adoption of the regulatory change is resulting in quite the opposite effect and may continue to do so if things remain unchanged.

Worth noting is that MiFID II is the second major regulatory change affecting the research industry since the turn of this century, following the 2003 Global Analyst Research Settlement (i.e. the "Spitzer settlement"), which aimed to separate investment banking and research after the clear abuses identified during the Tech Bubble era. At that time, there was a lot of political pressure to force more research independence through increased regulation, and for good reason, as there is little debate that research, banking, and trading should have some separation. How this occurs mechanically is complex, as it's seemingly impossible to require a bank to divest any of the three functions; therefore, formal walls were established to both limit and monitor interactions between individuals in each function. However, linkages in the economics of each business function were still allowed to exist despite the limitations on communications and the coordination of business efforts. This arguably still presents a potential problem for investment managers doing business in several avenues with investment banks. These linkages and the behavior they incentivize are the principal reasons why MiFID II is failing and ultimately may damage those it was intended to protect.

Why MiFID II is Failing, and What YTD 2018 Reactions Tell Us About the Future

What we have found in practice is that MiFID II has actually connected research, trading, and investment banking more explicitly, rather than separate them further. At firms with strong investment banking franchises, research analysts have become more tied to the outcome of the banking function. We've been told that at some shops, banking now pays for as much as 70% of the research budget. Similarly, at firms with strong trading franchises, analysts are still tied to the flow on the desk, even including electronic and derivative trading. While direct research payments have most certainly declined (we think by about 30% globally), trading flow has not. Data from publicly-traded banks shows that independent research shops with trading desks have seen less impact from MiFID II than research shops without trading desks. And since research payments are down, you would think that sell-side research budgets and/or the number of research analysts would actually decline, but this has not been the case at all. Research budgets are expected to be at least flat, and possibly even up y/y in 2018. Therefore, the funding gap is clearly being made up by payments from either investment banking or trading, or both.

As the business case for stand-alone research declines, banks have no choice but to further integrate research into their core profit centers. We don't blame them, we would do the same thing. In fact, we've fielded several inquiries from banks interested in buying our firm, but in each case the value they sought was not our pure value as a research operation, but instead the option value associated with helping them increase market share in investment banking and/or trading. This signals pretty clearly that MiFID II is actually taking us back in the direction of where we were pre-Spitzer. Clearly that's not what regulators intended.

Luckily MiFID II has only been formally adopted in Europe, but its rules have impacted almost all global money managers with a particular burden placed upon small/mid-sized globally-oriented firms. Based on what we've seen to date, we think MiFID II is highly unlikely to be adopted in the U.S. In fact, we think U.S. regulators are thrilled that Europe has put most non-U.S. money managers in a position of competitive weakness. But U.S. regulators are likely not pleased that MiFID II regulations have crept so easily into the U.S. – adding costs/burdens to an already struggling industry – at a time where regulators are increasingly worried about market liquidity and the health of market participants. We find several unintended consequences of the regulation that are already playing out just ten months since its adoption, several of which need addressing before irreparable harm is done to U.S. investment managers. Here are three of the bigger ones:

Street Coverage – The Economics No Longer Work for Small and/or Thinly Traded Stocks:

As the integration of research with trading or investment banking grows stronger due to the trends we outline above, the math for stock coverage begins to break down for a shockingly large number of publicly traded firms. After all, if your job as a research analyst is increasingly focused on driving trading flows and/or banking, then the incentive to cover small or thinly-traded stocks is marginal. Coverage skews up in market cap terms and shifts more focus onto those firms who either regularly raise capital or participate in M&A. In the Industrial sector, we see research coverage as much as 2x for those with a history of M&A, equity capital raises, or high trading volume vs. those firms with less attractive revenue prospects for a bank. It is becoming increasingly easier to find smaller companies that have only 2-3 analysts covering their stock today, down from 5-6 just a year ago. In fact, several companies have asked us if they will need to begin paying for coverage if the trend continues. And because of MiFID II trends, the answer is likely yes.

To further make our point, we know of many analysts with very low research market share who have compensation schemes well above Street averages; this is almost always observable in heavy investment banking-oriented sectors (look to Biotech for an example). None of this is illegal, of course, but is full of all kinds of pitfalls. We would equate it to a world where doctors work for pharmaceutical companies, willing to treat patients on the cheap, in order to get a piece of the action from their prescribed medicines. And legislation/regulation that encouraged such actions. MiFID II didn't untie the analyst/doctor from the trader/pharmacy – it did just the opposite. For investment managers, this results in misaligned incentives in many cases, as wide swaths of the broader market are important to invest in, but are far from banking-heavy.

Research Independence – Without Question on the Decline:

While it's obvious that the same conflicts of interest the Spitzer settlement was meant to address begin to arise in greater prominence in a MiFID II world, there are other related trends that are almost certain to weigh on the independence of research. The first is a disproportionate cost burden on smaller, independent research providers; those whose conflicts of interest with issuers are arguably the smallest. The need to document and catalogue every interaction with clients creates an unprecedented burden on smaller research providers. This can represent a steep tax that may pressure some providers into selling to larger banks or exiting altogether, removing more independent voices from the research landscape. Is it a coincidence that one of the largest boutiques, Autonomous Research, sold itself to Bernstein recently?

Secondly, given the buy side's difficulty in quantifying good vs. bad research in any simple fashion (as number of reports, phone calls, meetings, emails, etc. don't capture the massive subjectivity needed to discern research "quality"), we've seen a trend towards measuring/paying for quantity of deliverables (a la carte). While it may seem logical for buy-side counterparts to pay for specific actions (e.g. a phone call), the incentives drive behaviors away from the value-added research process and towards actions that create noise (and therefore…more phone calls). Also concerning is the shift toward (a la carte) payments for corporate access.

This emphasis on corporate access has resulted in increasing pressure on analysts to favorably rate securities. And finally, for all the sectors where banking/trading is not a particular priority, juniority in research coverage is an accelerating trend, one that also has hidden consequences for investment managers. While younger and/or less seasoned analysts arguably have the same ultimate potential that their predecessors did, early on in their coverage career they are less likely to venture from consensus views. And more likely to create noise in the system with inaccurate information. We find less experienced analysts struggle the most in understanding materiality and relevance. And in an effort to build a research franchise that their investment banking department may value more highly, they're likely to encounter outsized challenges staying independent. And to build a franchise more quickly, they typically feel pressured to create noise, often baseless stock calls, which in turn impacts markets and distracts portfolio managers, with no positive outcome for anyone.

Forced Relationships – A Consequence of Aggregated Sales Offerings and Price Dumping:

Unsurprisingly, in response to both declining assets under management in actively managed investment funds and the challenges that have been brought on by the adoption of MiFID II for global asset managers, the industry has responded by cutting down its number of suppliers. In many instances going from 80+ to ~30-35. In concept this sounds fair, but 95% of the time, what this means is a broker list that matches up with trading needs. One European client even said to us recently that they think Goldman Sachs research is bottom decile, but if trading wants any level of service, or if they want any piece of an interesting IPO, then they need to keep them on the list. They view our work as top decile, but in a world filled with large banks, and their need for global trading capabilities, we just didn't fit. And we're not the only ones, a list of 30 providers doesn't just cut out boutiques, it cuts high quality banks that most would conclude were all but immune from these pressures. It is the aggregation of trading/banking/research that drives this decision-making process, and from what we've observed so far at Melius, within investment managers, the consumers of research are almost always the net losers, with little or no say in the process.

Aside from the "number of providers" constraint, the other phenomenon that is widely observable is price dumping. The "JP Morgan Level" of price sets an incredibly low benchmark for the overall market, at ~$25k for access to written research in Europe, with a la carte pricing for other services on top of this base rate. At this price point, a firm like Melius could never survive. This is almost certainly a strategy to ensure they squash the threat of emerging research providers. It is no secret that the Street is terrified that its top analysts all leave for the boutique world. It has happened in investment banking with big share grabs by boutiques like Centerview, Evercore, Moelis, Lazard, Greenhill, Rothschild, PJT Partners, etc. The banks do not want to see research go down that path. And JPM was clearly comfortable that losses in research could easily be offset by gains in trading and/or banking, per the observations we laid out earlier. Interestingly enough, at the lower price point, has JPM taken down research staff or pay? We don't know exactly, but no chance they cut it by 60-80% which looks to be consistent with the aforementioned price cut. So maybe they have a lower cost base than us? No chance. Our total legal/compliance spend is so low (we are not regulated) that it would be nearly impossible for a bank to have a lower cost structure. We have significantly less overhead cost in virtually every imaginable function – rent, facilities, T&E, support, etc. We can only conclude that JPM is price dumping, and their research product is being propped up by a deeper pocket – banking or trading. But if this is the low price point and you struggle organizationally to quantify quality vs. quantity from your research providers (as many research consumers do, if they're even given a voice to choose) the one-stop shop argument forces you to choose the big bank as one of your providers, even despite the problems listed above.

Regulators and Research Consumers Should Desire Meaningful Change Before It's Too Late…

We sincerely hope that the buy-side and appropriate regulators will see right through this in due course. However, thus far the buy-side has struggled to separate quality from quantity in most cases. They have chosen suppliers that are large – just because it's easier to do so under MiFID II. Some have chosen pricing strategies that guarantee the failure of independent work and play right into the strategies of the larger trading firms. They have consolidated payments to award those with size – meaning large trading desks. They have treated all suppliers with equal disdain – much as the U.S. auto industry did 40 year ago. The end-result of that move was that technology and advancement was squashed – smaller entrepreneurial firms pushed out; those who could make the most widgets, with the least R&D spend overhang, won. And they have created artificial barriers to entry – MiFID II research trials that normally go nowhere. Measuring quantity (i.e., number of meetings/phone calls) vs. quality of interaction and its assistance with the research process. And taking the supplier discussion away from those closest to the product to those in the back office – farthest from the investment decision process. This is the result of misaligned incentives.

MiFID II as it relates to research and trading needs to be altered substantially, if not rewritten completely. It needs to decrease record-keeping requirements and it needs to address the harm the regulations have done to independent research. There is precedence here in how the Spitzer rules were written. And there is precedence in the overall banking sector in nearly every major country in the world. Smaller banks typically have different "stress test" requirements and a different regulatory framework overall. It would be impossible, for example, for a community bank in Buffalo, NY to have the same regulatory reporting requirements as Citigroup. Quite simply, MiFID II authors need to take market participant feedback and tweak as needed. The unintended consequences need to be addressed. Smaller money managers need to have a voice. Independent firms need to have a voice. Predatory pricing by large banks needs to be addressed. And entrepreneurial precedence needs to be taken into account.

Interestingly enough, hedge funds have quickly moved to capitalize on the regulatory failures, as well as the responses to them. Hedge funds, in general, have less bureaucracy and push the research provider decision down to the analyst/portfolio manager. They emphasize supplier differentiation and quality. They seem to have a heightened awareness to the cost of inaccurate information and conclusions based on bias. We find them to be more nimble than their long-only competitors and can pick best-in-class research providers, best-in-class prime brokers, and get the maximum value for their spend. We find our hedge fund clients to be our most transparent relationships. They emphasize quality and are the first ones to let us know if we are falling short.

Most of the long-only investment community is stuck in the middle; all but the biggest mutual funds in fact. They may lack the trading volume of a hedge fund and therefore be back-of-the-line with pretty much any bank. They won't get liquidity in a downturn. They will get access to the weaker IPOs, but not the most promising ones. Their mutual fund clients will ultimately be the ones to suffer. ETFs lack the regulatory scrutiny and can win the price game. But what kind of liquidity are we going to have when/if investors run for the exit door on these products? A healthy money management industry needs balance. Active managers have a critical role that cannot be marginalized. And if they are unwilling to address the unintended consequences that have already begun to emerge as a result of MiFID II it will eventually hurt their own franchises by squeezing out the resources best equipped to help them fend off ETF competition and win in this new world. MiFID II creates imbalance. It has unfairly burdened European money managers the most. It has hurt the small suppliers and emboldened the large. There will always be a place for well-thought-out regulation. But it should not come at the cost of healthy competition, fair dealing, and true market pricing.