The MiFIDs are Coming!

How Changes in Corporate Access and Investment Research in Europe Could Impact the Financial Community and U.S. Public Companies in 2018 and Beyond

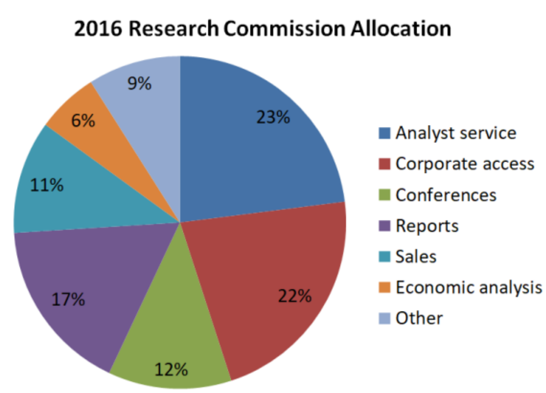
Remember when Regulation Fair Disclosure (Reg FD) arrived in 2000? Wall Street veterans, C-suite executives and investor relations (IR) professionals heralded the new rule with predictions of terrible, sweeping changes to the status quo. But, by and large, all parties adapted quickly to the new rules.

However, things may not go as smoothly next year as a regulatory change set to take effect in Europe on January 3, 2018 could have a significant impact on the investment community (and by extension, the IR and corporate communications world). What is also surprising is that some publicly traded, U.S. companies seem unaware of the upcoming change or its potential ramifications.

The Markets in Financial Instruments Directive I, otherwise known as MiFID I (pronounced "miff-id"), was announced in 2004 and took effect in 2007. In 2014, the European Commission, European Parliament, and Council of the European Union agreed on MiFID II, a comprehensive overhaul of its predecessor intended to further harmonize regulation of investment services across Europe by targeting a broader group of firms and instruments.[1]

MiFID I didn't hit the radar screens of most publicly traded companies in the United States, but that is unlikely to be the case this time around. MiFID II is expected to materially impact U.S. public companies due to changes in corporate access and investment research regulations – two areas where major global investment firms may prefer to streamline compliance under E.U. regulations rather than operate under two sets of rules – which could push smaller U.S.-only firms to follow suit.

Under the traditional bank and broker-dealer operating model, asset managers pay a bundled trading commission rate that covers trade execution, investment research and stock recommendations, *and* access to corporate executives the banks facilitate with their buy-side clients. Over time, traditional equity research reports / opinions have become less important to the buy-side (just 17 percent of research commissions in 2016 versus 25 percent in 2005), while face-to-face corporate access has become significantly more important (22 percent in 2016, up from 18 percent in 2005), according to Greenwich Associates data.



[1] *European Union, Iceland, Norway, and Liechtenstein*

The Changes in Europe

Among other requirements, ***MiFID II will mandate that investment firms offering equity research and/or corporate access services provide and price these services separately from each other, and separate from trade execution services***. According to the regulators, an asset manager is likely to consider investment research and meetings with a company's management team a "major" inducement to trade through a given broker. Regulators see unbundled fees as a way to remove this potential conflict of interest, or "inducement risk." Under MiFID II, asset managers will no longer be permitted to direct stock trades to a given broker's trading desk in return for the promise of securing a favored spot in investor conference one-on-one or non-deal roadshow (NDR) meetings.

Corporate Access

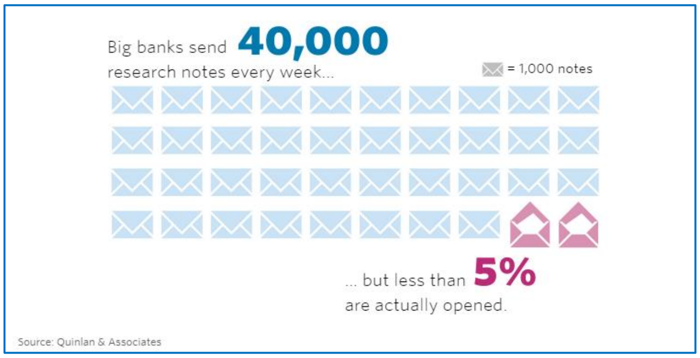
The MiFID II rules on corporate access were clarified in recent months by the European Securities and Markets Authority (ESMA). ESMA stated that corporate access must be priced accurately – not as a nominal charge – to ensure it is a standalone service and not dependent on research or trading desk services. Unlike equity research reports, corporate access must be paid for through the asset manager's P&L, not from a research report payment account that is funded by the asset manager's clients' assets.

However, ESMA specifically excluded meetings with executives that are set up or facilitated by a company's IR department, or a third-party corporate access service provider that does not provide other investment services regulated under MiFID II. Likewise, an investor roadshow paid for by an issuer to support a capital-raising event, be it an Initial Public Offering ("IPO") or secondary offering, and that is freely and publicly open to analysts from investment firms and other investors, "could be capable of qualifying as [an] acceptable minor non-monetary benefit" and, therefore, would not fall under MiFID II restrictions.

Investment Research

Thus far, the media has primarily been writing about MiFID II's potential impact on the sell-side business model. Sell-side equity research is already under tremendous pressure given the rise of passive investing and exchange traded funds (ETFs), expanded internal buy-side research capabilities (especially at larger firms), and the amount of information freely available today – all of which have increasingly reduced reliance on sell-side equity research. In 2016, actively managed funds had $285.2 billion in outflows, while passive funds had $428.7 billion in inflows, according to Morningstar. Index funds alone now account for roughly 35 percent of total equity fund investments. This fact is further evidenced by significant staffing reductions in most sell-side equity research departments in recent quarters.

Unbundling fees for bank and broker-dealer equity research will force these individual sell-side services to operate as separate, free-standing profit centers – and may be a wake-up call for asset managers. Quinlan and Associates estimates that more than 40,000 research notes – "from comprehensive reports to minor updates linked to corporate announcements" – are sent out every week by the top 15 global investment banks alone, but less than 5% are actually opened by their intended recipients. Most buy-side managers surveyed said that, when they do read sell-side equity research notes, they focus on the executive summary and key takeaways. For these reasons, future a la carte pricing of individual sell-side services will almost certainly lead to a precipitous decline in sell-side reports "purchased" by the buy-side.



Infographic source:
https://www.wsj.com/articles/analyze-this-new-bank-research-rules-spark-price-war-in-europe-1504954802

What will happen and when?

Investment banks surveyed by McKinsey & Company expect an industry-wide decline in equity research revenues over the next three years. European asset managers that decide to pay for research in full could see significantly reduced profits. When it all shakes out, McKinsey expects:

- A handful of global banks will continue offering both global execution services and broad-based equity research coverage;
- Some banks will likely opt to solely focus on either execution or equity research;
- Most banks will focus on equity research and execution in local sectors and regional markets where they have specialized expertise; and
- Independent research firms that don't offer execution will avoid MiFID II, enabling them to grow over time.

While McKinsey predicts "big cuts" in sell-side equity research teams, it also expects larger buy-side firms to place greater emphasis on in-house equity research capabilities. While these changes should increase buy-side demand for corporate access, the new MiFID II rules will likely reduce the number of sell-side conferences and broker-organized NDRs that buy-siders attend, given the incremental cost component that did not previously exist.

To comply with MiFID II, brokerage firms in Europe are offering subscriptions for published research, either from a single equity research analyst or from a bank's entire equity research analyst staff; bundled pricing that combines published reports and regular access to analysts; and combinations of bundles for larger clients. Based on numerous media reports regarding equity research price "negotiations" currently occurring between several large investment banks and their respective asset management clientele in Europe, this is an extremely fluid and dynamic situation.

"For resources that are truly scarce and perishable, such as private meetings arranged with corporate managements, research firms may choose to hold auctions among interested clients," McKinsey predicted. But the jury is still out on both demand and pricing, and in our opinion this new structure could lead to additional legal scrutiny surrounding the fair dissemination of information by company management teams in private investor meetings. Just six months ahead of MiFID II's implementation deadline, 34% of alternative asset managers were undecided on how to purchase research, according to a survey by the Alternative Investment Management Association (AIMA). The trend is similar among traditional asset managers, based on another survey by Greenwich Associates.

Implications for North America

How much and how quickly will MiFID II affect companies that are headquartered in the United States and Canada?

While McKinsey predicts three to four years, our team at Lincoln Churchill Advisors are among those who expect significant changes to occur in 2018. Widely held companies in the Fortune 500 are unlikely to see a major impact from MiFID II, since most institutional investors will consider equity research from top-ranked sell-side analysts on – and meetings with – these companies essential. At the other end of the spectrum, micro- to mid-cap companies will see the most adverse impact. ***We expect MiFID II to accelerate the trend witnessed over the past decade: reductions in sell-side equity research coverage and restrictions on corporate access as Wall Street firms focus on covering and trading the largest, most-profitable companies at the expense of smaller, less-liquid companies*.**

Frankly, MiFID II may be the catalyst for some firms to make the tough decision to further reduce or eliminate their equity research teams. As it stands today, many micro- to mid-cap companies already suffer from insufficient sell-side equity research coverage, placing them at a major disadvantage in terms of visibility with institutional investors.

In recent conversations with institutional sales teams and sell-side analysts, we have heard comments including:

- "It's a topic we are discussing every day, but we just don't have clarity; it's very concerning to us."
- "There is more conjecture than fact at this point, but the worst-case scenario is potentially disastrous for us."
- "It's going to be interesting to see if some of the big firms make a move in 2018, and does it lead to a domino effect across the industry?"

It is too early to accurately predict all the long-term ramifications, but it is certainly going to create additional near-term uncertainty for many public companies and Wall Street veterans. Over time, we will see answers to our questions about the long-term implications:

- Will equity research teams split off from banking/trading-focused firms, but largely maintain their structure, creating a direct pay-for-research model?
- Will there be an increase in "pure" research firms that cater to investment firms that are too small to have significant internal equity research teams to cover all sectors?
- Will U.S.-only firms that have doubled down on covering small-cap stocks ultimately win out due to their specialization, or will they be forced to match the larger global firms?
- Will we see a new breed of IR counsel and corporate access firms, taking the role traditionally filled by banking/trading-focused firms, especially for micro- to mid-cap stocks?

While the sell-side has historically served as an important independent extension of many companies' IR programs, providing both heightened visibility and investor access, it is increasingly clear that the changing regulatory landscape will force many public companies to reduce their reliance on the sell-side to promote their investment stories. Companies large and small will be well-served by reviewing their IR programs. The need for proactive IR is exacerbated by the growth in passive investing and increased competition for actively managed investment capital. With this in mind, we believe every company should consider undertaking the following actions:

- ***Communicate internally and externally.*** Internal communication priorities: If you are an IRO, now is the time to communicate these potential issues to your management team. If you are a C-suite executive, alert the Board of Directors at your next meeting. Starting the dialogue now is crucial to avoiding concerned questions from your CEO or Board and/or potential fire drills in coming months as the full ramifications of MiFID II become clear.

  External communication priorities: Discussions of MiFID II are pervasive within the investment community, but not during discussions with public companies. In your ongoing conversations with current sell-side analysts, seek their opinions of how the rule changes will impact their role, their firm, and the overall financial community. In addition, reach out to trusted buy-side contacts. IROs are well placed to facilitate these conversations, and until the ramifications become clearer, it would be good to understand the likely impact from firms you deal with directly, and begin contingency plans where necessary. Most of the conversations we have had highlighted which analysts and firms are more concerned than others. While unwilling to go "on the record," many used our conversations to voice their concern.

- ***Proactive shareholder engagement and targeting.*** With potentially fewer opportunities to meet investors through sell-side-sponsored conferences or NDRs, it will be critical to find prospects whose investment strategy best matches your company's profile – and to proactively maintain contact with not just existing shareholders, but the former and potential investors you have met over the years. Public companies may need to expand their own outreach to arrange meetings and trips that were previously set up by the sell-side, or work with consultants to ensure the time spent on IR is both efficient and effective.

- ***Hone your investor message.*** As mainstream brokerage firm sell-side equity research dwindles – or even disappears for many smaller companies – a clear, concise and compelling investor message will be essential to ensuring the company is not overlooked by investors. As with the rest of the world, investors' attention spans are getting shorter and they are constantly bombarded with information. The best way to remain visible is to work to constantly hone your message and deliver it effectively, via both traditional and cutting-edge formats and channels. This should incorporate regular training on delivery and becoming more creative with standard IR events, such as properly scripted quarterly earnings calls and Investor Days.

- ***Increase your visibility.*** Given the massive choice of potential investment opportunities, both domestically and internationally, it seems clear the already-fierce competition for capital is set to intensify. Companies will need to take control and be more proactive. Consider new avenues to increase the visibility of your management team, business strategy and investor messages, including media coverage, proactive industry analyst relations, industry conference presentations, Investor Days and tours of your headquarters or operations. Leverage both digital and traditional communication channels to reach new audiences and stand out from the crowd that's competing for finite investor funds.

- ***Create contingency plans.*** As you plan your 2018 IR goals and strategies, plan for scenarios that assume you lose some sell-side coverage and subsequently receive fewer invitations to participate in conferences and NDRs. The scenario for each company will vary greatly based on market capitalization, liquidity and industry sector, but understanding what might happen and how you should adapt will put you in good stead.

Ultimately, while concerns over changes to be driven by MiFID II may turn out to be as overblown as initial concerns about Reg FD and other regulations, taking a “wait and see” approach is risky at best. Despite all this uncertainty, one thing is clear: active institutional investors will still need a way to connect with and access information on the public companies they own – while also finding new companies for potential investment. What is not clear today, are the exact mechanisms that will be used to make those connections. Taking an informed, proactive approach will play a critical role in determining how successfully your company will navigate the changes.

For more information on this topic, please contact Lincoln Churchill Advisors (www.lincolnchurchilladvisors.com).

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