MIFID II: TRAILBLAZER OR DAMPENER FOR CAPITAL MARKETS?

THE REGULATION HAS ALREADY STIRRED UP EQUITY INVESTING IN EUROPE

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Overview

The Markets in Financial Instruments Directive (MiFID II) regulation, with over 1.4 million paragraphs of rules, has been designed with the agenda of restoring investor confidence and making the European market safer and more transparent. MiFID II covers all categories of trading within the European Union (EU), irrespective of the fund manager's location.

After 17 months of implementation of MiFID, some interesting trends have been revealed, especially pertaining to aspects such as unbundling of trading and research costs. On the one hand, smaller companies are running the risk of losing out on institutional investors. This is an outcome of the sharp decline in paid research, preventing cost-sensitive banks from researching smaller firms. On the other hand, new ventures are emerging, which seek to research ignored small and mid-cap stocks. Increasing grievances from small and mid-sized investments firms might catalyze a review in the near future. However, the benefits of increased transparency that MiFID II facilitates must be kept in mind.

WNS DecisionPoint™ takes a closer look at the impact of MiFID II on various stakeholders of the European market.

Key highlights

- The scope for Markets in Financial Instruments Directive or MiFID II extends to all aspects of trading with the European Union and pushes electronic trading over phone transactions
- Under the regulation, fund managers should budget separately for research and trading, causing the research coverage of small and mid-sized companies to be left out
- Asset managers should show cost break-ups explicitly which is driving down brokerage profits

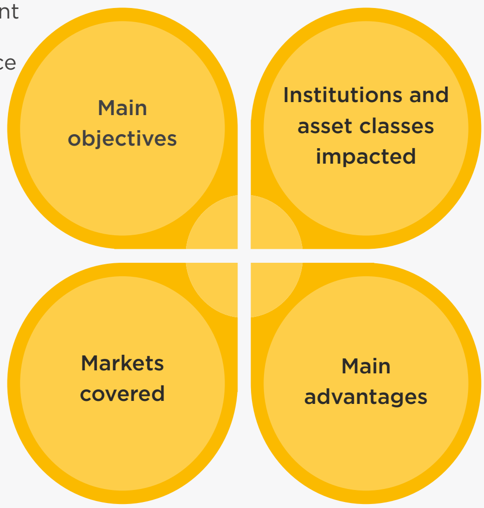
INTRODUCTION

The refurbished version of the Markets in Financial Instruments Directive, or MiFID II, was designed to offer better protection and increased transparency to all asset classes, ranging from equities to fixed income and foreign exchange. Implemented on January 3, 2018, the MiFID II has more than 1.4 million paragraphs of rules, which have increased in complexity since implementation.

Exhibit 1

Overview of MiFID II

- To make European markets safer, more transparent and more efficient
- To restore investor confidence following the financial crisis
- To transfer a significant part of over-the-counter trading to regulated raining venues



- Banks, fund managers, exchanges, trading venues, high-frequency traders, brokers, pension funds and retail investors

- Equities markets, fixed income, commodities, currencies, futures, exchange-traded products and retail derivatives such as contracts-for- difference

- More pricing transparency for off-exchange markets
- Volume caps for equity 'dark pools'
- Splitting payments for analyst research and trading commission Tougher standards for investment products

Source: FT Research; WNS DecisionPoint™ Analysis

REGULATION WITH OVERARCHING CHANGES

The new rules cover all aspects of trading within the EU. If a fund manager wants to buy an underlying product listed in the EU, such as a bank option in Hong Kong, it will fall under the scope of MiFID II, irrespective of the fund manager's location.

The MiFID II goes beyond the instance listed above. One of the key differentiating features of MiFID II is the aim to push more trading away from the phone and on to electronic venues, which possess better audit and surveillance trails.[1] That will lead to a surge in data, which will be measured in petabytes. It is now mandatory for institutions to report more information about most trades immediately, including price and volume.

Trades will also be timestamped, to 100 microseconds for some, while information in documents for transaction reporting will stretch to more than 65 fields. It must be stored for a minimum of five years, while banks and brokers will have to compulsorily show customers that they were offered the best available price for their trades.[2]

1. Article by Financial Times, What is MiFID II and how will it affect EU's financial industry?, September 2017
2. Ibid

CHANGING THE WAY OF INVESTMENT DECISIONS

One of the most prominent aspects of the regulation governs the way asset managers pay for the research they use to make investment decisions. Before the introduction of MiFID II, asset managers received research, including written reports and analyst phone calls, free of charge. These research costs were later incorporated into the trading fees, which had to be settled by the end clients. Under the new rules, fund managers will now have to budget separately for research and trading costs, a move known as unbundling.

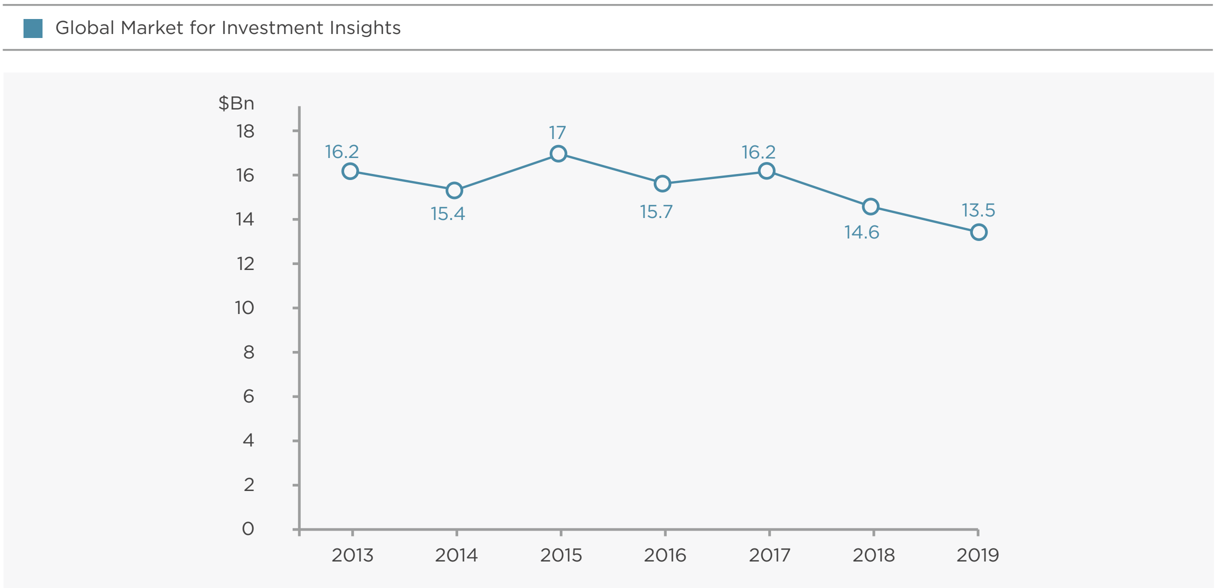
The new mechanism on research payments poses notable challenges for U.S. brokers. Local rules do not permit U.S. brokers to receive direct payments for research unless they are formally registered as investment advisers. However, a 30-month exemption has allowed U.S. banks to accept payments from European fund managers.[3] The U.S. Securities and Exchange Commission has signaled that the regulator would support routes around the U.S. rules that fund managers have crafted, enabling them to strike a unifying standard for research payments. How it will take shape is yet to be decided.

ASSESSING THE IMPACT OF MIFID II

Seventeen months on, MiFID II is changing the investment banking business, with asset managers concentrating their negotiating power on a smaller list of the largest brokers. The regulation seems to have shrunk the research coverage, particularly among small and mid-sized companies.

Exhibit 2

Global Market for Investment Insights

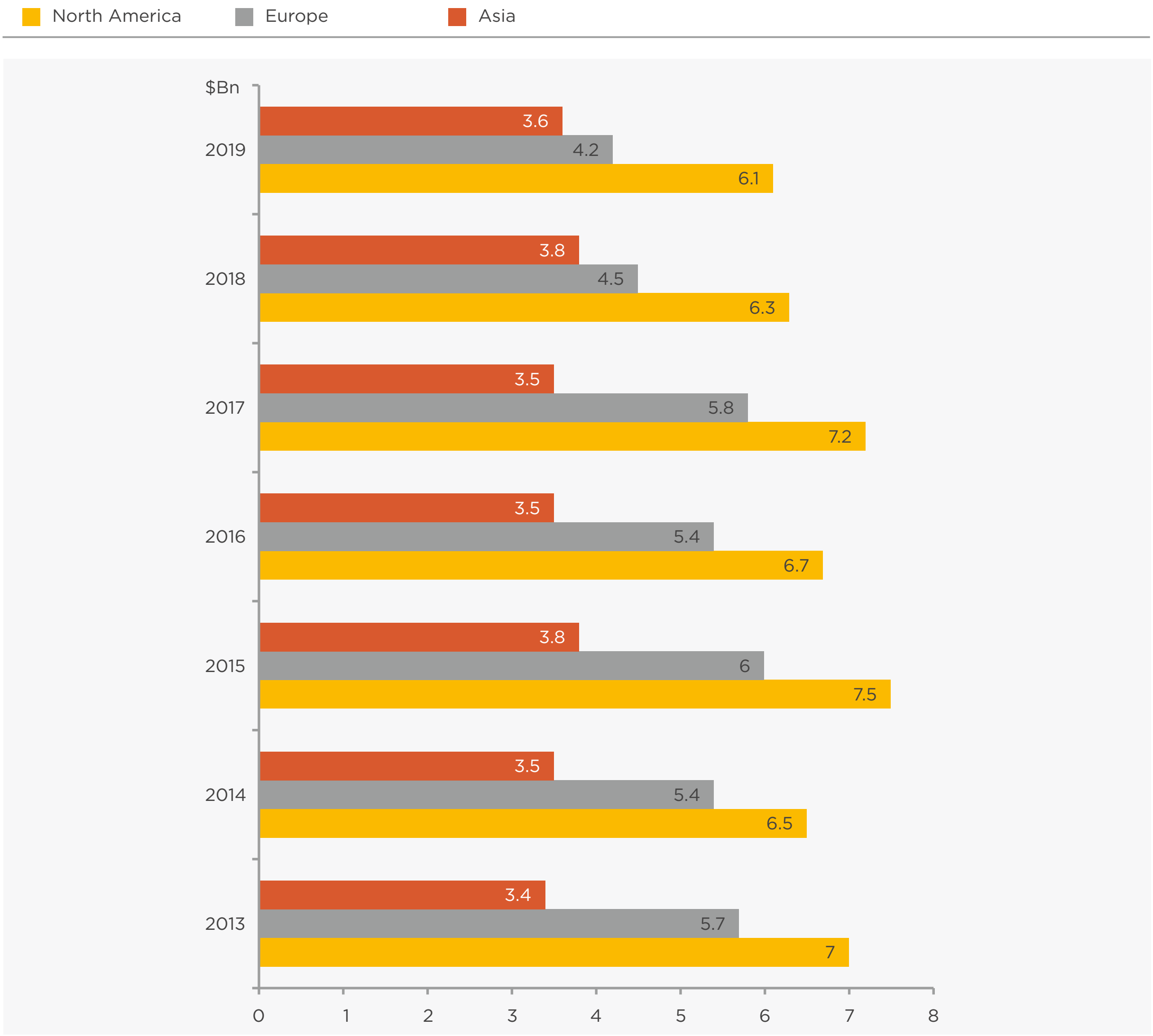


Source: Ft.com

3. Article by Financial Times, How MiFID has made its mark in the US, May 2019

Exhibit 3

Fund Managers Reduce Research Spending



Source: Ft.com

MiFID II has imposed cleaner divisions between payments for trading and those made for research. The new standards imply that asset managers need to pay for the research they use, rather than simply sending their dealing commission to banks. This has profoundly impacted the entire sales, trading and investment banking infrastructure in Europe.[4]

According to a survey in February by the CFA Institute, nearly 60 percent of asset managers were taking less research from banks than they were before the introduction of MiFID II. The price asset managers pay for research has also suffered a steep decline, thereby squeezing banks' profits.[5] The fears that niche segments would bear the brunt of unbundling and the regulation would raise barriers to entry for small mid-cap specialists appear to have realized, with a wave of cutbacks by brokers such as Canaccord.[6]

4. Article by Financial Times, Where now for the rules that rocked European finance? May 2019
5. Ibid
6. Ibid

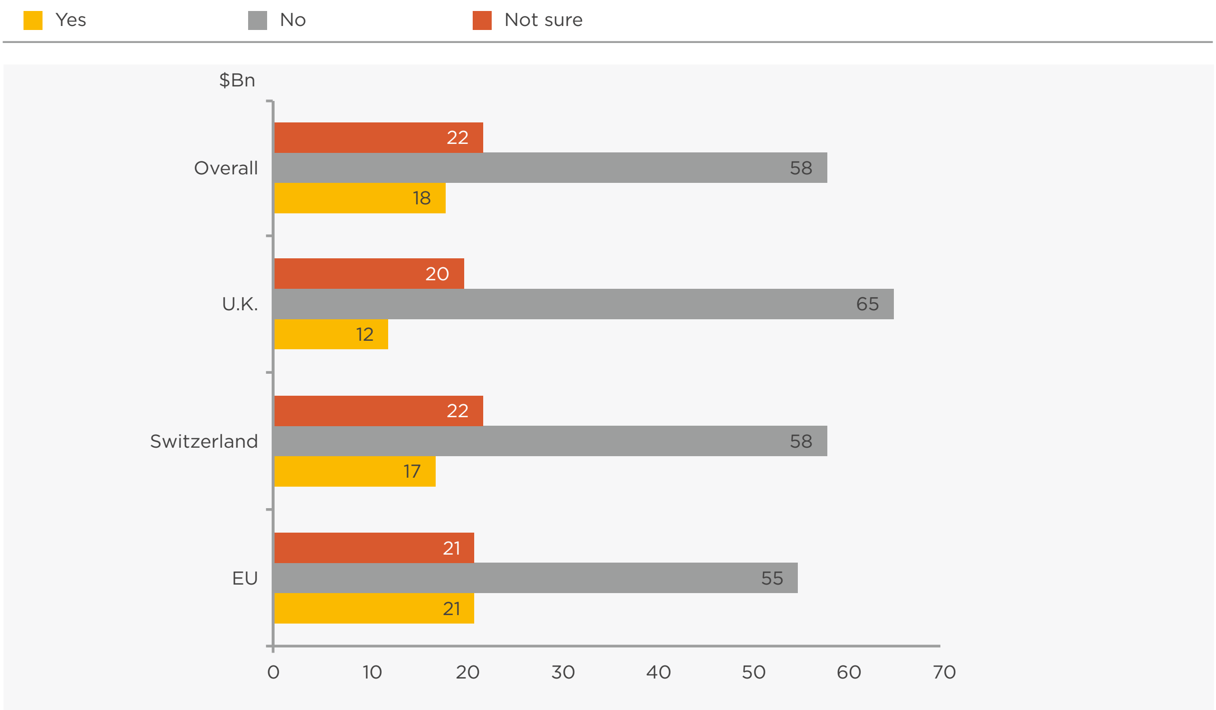
MiFID II could also create a vicious circle, where cost-conscious banks stop researching smaller companies. Those companies could then lose their profile among institutional investors and their stock becomes less attractive and trades more cheaply, making it less appealing for investors to buy and for brokers to cover.[7]

The European Commission, which proposes legislation, is now preparing a review, after receiving several complaints especially from small and mid-sized investment firms in this area.[8] However, there is no clarity as to whether there is a genuine political will to make changes. European elections have delayed tweaks to the regulation. Furthermore, not everyone is in favor of making sweeping amendments to the regulation. Most EU managers produce market research on their own or buy only what is needed from banks.[9] According to the U.K. Financial Conduct Authority, the market disruption caused by MiFID II is a price worth paying for increased transparency.

Some areas still remain uneasy. A study by Italian regulators into MiFID II's effects found more research was being generated to benefit computer-based and algorithmic-driven research.

Exhibit 4

Is Mifid II Benefiting End-investors?



Source: CFA Institute. Original question: "Overall, do you believe MiFID II reforms are delivering better outcomes for end-investors?"

7. Ibid
8. Ibid
9. Ibid

Despite the challenges, the market has started filling gaps. Bolsa de Madrid (BME), the Spanish exchange operator, for example, has started a venture with local financial analysts to provide independent coverage after finding 60 listed small and mid-cap stocks that were previously not tracked.[10] There could also be a form of incentive from the government in the near future, such as a tax credit, to stimulate research reports on small to medium-sized companies.[11] Public-private collaboration and EU-wide standardization of reporting requirements will also make research cheaper.[12]

10. Ibid
11. Ibid
12. Ibid

CONCLUSION

MiFID II is already shaking up equity investing throughout Europe. Requiring asset managers to pay separately for research, thereby forcing brokers to lay out the details of its cost explicitly, has led to a steep drop in spending.[13] That has affected brokerage profits, resulting in a reduction of the quantity and quality of research they do.[14] Smaller companies are the ones research providers have dropped from their coverage. Less broker attention could result in less investor attention, thereby making such companies' stocks less liquid and this, in turn, would be still less attractive for investors.[15] A remedy for this could be that asset managers undertake their own research, or for non-brokerage companies to find a profitable niche in it.[16]

If MiFID II unintentionally makes capital markets less accessible to smaller companies, that reflects a failure in the market for company information. The cost of researching a company is directly related to its size, which is also one of the prime reasons small companies are undercovered. When markets underprovide a public good, such as valuable information, public intervention becomes inevitable.[17]

In order to prevent MiFID II turning into a bane for capital markets, all solutions need to be pursued within the EU's capital markets union agenda. That agenda will ensure adequate liquidity for smaller EU companies.

13. Article by Financial Times, How to guard against MiFID's unplanned effects, May 2019
14. Ibid
15. Ibid
16. Ibid
17. Ibid

About DecisionPoint

Making key decisions that improve business performance requires more than simple insights. It takes deep data discovery and a keen problem solving approach to think beyond the obvious. As a business leader, you ought to have access to information most relevant to you that helps you anticipate potential business headwinds and craft strategies which can turn challenges into opportunities finally leading to favorable business outcomes.

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