“Every revolution seems impossible at the beginning, and, after it happens, it was inevitable”: *Bill Ayers*

By Keith Hiscock CEO, Hardman & Co

Source: Shutterstock

“There is clearly going to be a substantial change...”

As we approach 3rd January 2018 and the coming into force of the MiFID II legislation which changes the landscape for research, we are beginning to see some of the practical implications and complications. Brokers are in the early stages of working out how to structure charging for research, asset managers have already begun cutting their brokers’ lists and a model code of conduct for Research Payment Accounts for institutions has been published.

Most of the discussions on MiFID II, and pretty well all of the media coverage, have focused on its impact on the volume of research. There is clearly going to be a substantial change, with far less research published, and most, if not all companies with market capitalisations below £600m, finding only their house broker deems it commercial to write about them.

There has been far less consideration of MiFID II's effect on the distribution of research, which will be equally seismic. Today, to all intents and purposes, all institutional brokers have the same client and distribution list. From January 2018, institutions will dramatically cut the number of brokers with which they engage. The strength of a broker's institutional network is going to become a key point of differentiation.

Brokers price discovery

"Brokers and institutions have been trying to figure out a pricing mechanism for research…"

The process which has been going on for the last few months can best be described as a peacock's mating ceremony. Brokers and institutions have been trying to figure out a pricing mechanism for research in the new environment. We understand that, broadly, brokers first approached institutions for some sense as to what they expected to pay and for what. Brokers were swiftly sent away and told to come up with the first draft. Some brokers have suggested one price for everything for an entire institution, others a price for everything for each individual fund manager. There have also been some menu pricing proposals. Often the final figure proposed for an institution turns out to be magically the same as they are currently paying.

"At the moment, the price seems to be related to the size of the fund, not to the volume of research…"

We have heard of one 'bulge bracket' proposing to charge £1 million to an institution for digital access to everything, whilst another wants £30,000. This is not like selling Mars bars. At the moment, the price seems to be related to the size of the fund, not to the volume of research. Additional charges are made for lunches, sales calls and analyst meeting time.

The difficulty in pricing research - other than calls, meetings and lunches - is that it has hardly ever been done before, and providing it is a marginal cost game. Charging everyone marginal cost is financial suicide. At the risk of teaching granny to suck eggs, consider the table below.

Why brokers' marginal cost per client is so different from average cost

£ Scenario A - 100 clients		£ Scenario B - 101 clients	
Analyst cost	100,000	Analyst cost	100,000
No of Institutions	100	No of Institutions	101
Cost per email	1	Cost per email	1
Total cost of emails	100	Total cost of emails	101
Total cost	100,100	Total cost	100,101
Average cost per client	1,001	Average cost per client	991
		Marginal cost for client 101	**1**

Source: Hardman & Co Research

"This dramatic difference between average and marginal cost illustrates the difficulty for brokers…"

Scenario A assumes the broker has 100 clients, the analyst costs £100,000 a year and that one piece of research is sent by email at £1 a time (ludicrously high, we know, but bear with us). The average cost of servicing these clients is, of course, £1,001. In Scenario B, an extra client is added. The average cost of providing research to 101 clients now falls to £991, but the marginal (for non-economists, the extra) cost of servicing client 101 is £1. Of course, if every client was charged the marginal cost of the 101st client, the firms revenue would be £101 and it would make a huge loss.

This dramatic difference between average and marginal cost illustrates the difficulty for brokers – most of the cost is fixed. Of course, the 101st client may well require more than just an email with the research, such as a regular call from a salesman or an hour's meeting with the analyst and this would be easier to price.

This period of price discovery is likely to last well into 2018 and the final pricing model will gradually emerge. In the meantime, expect chaos.

MiFID II's impact on distribution

"In the current environment, brokers' investment client/distribution lists are nearly identical..."

It is becoming clear that asset managers are going to reduce dramatically the number of external research providers they use. In the current environment, brokers' investment client/distribution lists are nearly identical. It is true that Broker A may have a better relationship than Broker B with Standard Life, but the opposite might be true for M&G – the key fact, though, is that every broker has a line into every major investor. This is going to change.

In our conversations with institutional investors and wealth managers, we are being told that their lists will have to be cut. They may only want waterfront research coverage from 3 'bulge brackets' and whole swathes of small and mid-cap brokers will be cut off completely. If institutions' commission pot is going to fall 50% or so (as seems likely), they have the choice of cutting payments to all their brokers by 50% (and probably getting a much worse service) or concentrating it on the firms they really value – the evidence is that they are opting for the latter.

"...MiFID II includes an exemption for house brokers' research..."

Even in the past week we have seen Union Asset Management, Germany's third largest asset manager, announce that it will halve the number of external research providers across Europe (i.e. brokers primarily) from 200 to 100. Amundi said in April that it had already halved its list. Some small and mid-cap fund managers wonder whether they will pay for anything, since they are expecting to get house brokers' research for free and there may be little else available – MiFID II includes an exemption for house brokers' research, which can be sent to any (FCA-registered) investor for free, since it has already effectively been paid for through the corporate retainer.

Company managements need to recognise that, even if a non-house broker publishes on them, their distribution might be very limited, even among institutions, let alone private client brokers and wealth managers. And, of course, retail investors will still be off limits, even though they are often the key source of daily liquidity.

Very little has been written on this implication of MiFID II.

Code of Conduct

"Very little has been written on this implication of MiFID II".

An organisation called Substantive Research has consulted with 50 asset management organisations to produce a draft code of conduct for Research Payment Accounts (the option where fund managers agree upfront with their clients a fixed amount to charge the fund for buying in research)[1]. The Code seeks to meet the core principles of transparency, governance and alignment of interest.

[1] Substantive Research 'The RPA Code of Conduct' 01-03-2017, clause 2, vii

The Code is a good first effort at coming up with some common rules. However, it raises some practical questions which the regulators probably did not consider when proposing MiFID II.

Cost price: 'Asset Managers will perform an assessment to identify situations where pricing of research has become so discounted as to potentially constitute an inducement (for example, where it is clearly being offered below cost price).

MiFID II makes it clear that asset managers cannot receive research for free (with the exception of house brokers' research, referred to above), since this is an inducement (a polite word for a bribe) to deal with them.

"...how will asset managers know what the cost price is..."

The Code of Conduct is right to extrapolate that this means that receiving research at less than cost price is as much an inducement as sending it out gratis. The difficulty is how will asset managers know what the cost price is. In Table 1 above, should asset managers use the average cost or the marginal cost? Even if they decide it is average cost, how can an external party know what a particular broker's average cost is without knowing their cost structure? - What are the costs, how much relates to research and how much to corporate, and by how many clients should the total cost be divided?

Clearly accepting research for free or, say, £100 is an inducement. Beyond that how can an institution possibly know the cost – the brokers don't!

Valuation: The Code provides advice on how fund managers should evaluate research. 'The valuation process will include metrics that assess the usage of research from the specific Provider as well as qualitative feedback'[2].

The risk has always been that fund managers end up rewarding volume of service, rather than value. The reality is that currently a broker who has 4 cracking ideas a year will likely get less reward than one who has 250 really mediocre ones. Worryingly, the Code confirms that 'Consumption metrics will be maintained for all external research funded by clients through the RPA. These will cover, for example, analyst meetings, telephone calls, emails or other direct messaging communications, as well as the accessing of research platforms, mobile apps, written publications, quantitative models and conference calls, and customized solutions'[3] – no change there, then.

"...Consumption metrics will be maintained for all external research funded by clients..."

Cross-subsidisation: 'A vote will bind the individual Portfolio Manager ("PM") to the supply of Research that they can expect to receive. If they do not vote for a research provider, they cannot receive research from it, even if a colleague within the same fund has voted for that provider and has access accordingly'[4].

Is this really going to happen? Consider this. Fred and Freda run the Widget PLC Senior and Junior Pension Funds respectively at Updown Fund Managers and sit next to each other. Fred values Broad Street Brokers' research highly and allocates some of his commission pot to pay for it, but Freda is indifferent to BSBs work so does not pay for it. Fred receives a note from BSB with a strong sell recommendation on Acme Intl. Acme is the biggest holding in both the Senior

[2] Substantive Research 'The RPA Code of Conduct' 01-03-2017, clause 3, iv
[3] Substantive Research 'The RPA Code of Conduct' 01-03-2017, clause 3, v
[4] Substantive Research 'The RPA Code of Conduct' 01-03-2017, clause 3, vi, c

and Junior Pension Funds. How likely is it that Freda will not get wind of this, and see the research?

Client allocation & reporting: 'The method used to calculate the charge per client can be based on a variety of criteria, but will be published in full for clients. These methods may include but not be limited to the proportion of AUM (Assets under Management) represented by the client within the AUM of each applicable research budget'[5].

Some might argue that this is not in the spirit of MiFID II. Imagine that Widget PLC Senior Pension Fund has £10 bn of equity assets, whilst the Junior has only £100m. They have identical holdings. Under the Code, the pensioners of the Senior Fund might pay their fund manager £100,000 for buying in research, whilst the Junior would pay £1,000 - for exactly the same research. By calculating the charge per client based on AUM, it can be argued that the Senior Fund is subsidising the Junior.

Conclusion

MiFID II is going to be a revolution in capital markets, akin to the 'Big Bang' of 1986. Having hoped it might just go away, institutional investors and brokers are only beginning to address its implications.

It should be understandable that it will take some time for the market to find an acceptable pricing structure. Brokers client list are going to diverge dramatically. There are a host of other issues for professionals to solve, which Substantive Research's 'The RPA Code of Conduct' makes a good start in addressing.

3rd January 2018 will be a momentous day. It may only be the end of the beginning though, rather than the beginning of the end.

About the author

Keith Hiscock is the Chief Executive of Hardman & Co.

He is personally responsible for the firm's relationships with its corporate clients and also for corporate finance.

Keith has over 35 years' stockbroking experience and has developed long-standing relationships with many major institutional investors including Private Client Brokers and Wealth Managers. He started his career at James Capel, at the time the top ranked research house in London. He was a founding member of Schroder Securities and of Agency Partners, a leading research boutique and a member of the 5-man securities board at Evolution. Keith has also advised companies, large and small, on their relationships with the capital markets. Keith was part of the group of investors which acquired Hardman & Co in late 2012. He holds an MA in Philosophy, Politics & Economics from the University of Oxford.

[5] Substantive Research 'The RPA Code of Conduct' 01-03-2017, clause 7, iii

Notes

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