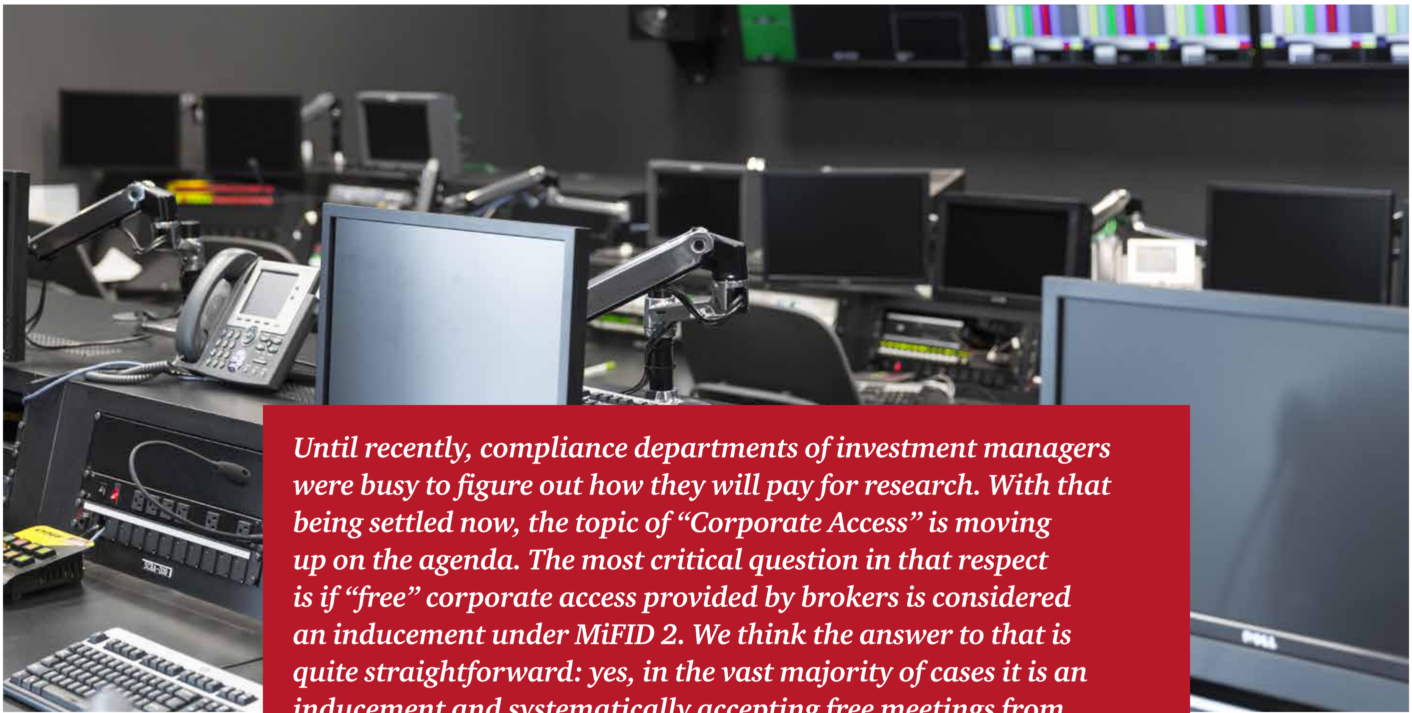
Free "Corporate Access" provided by brokers is an inducement under MiFID 2



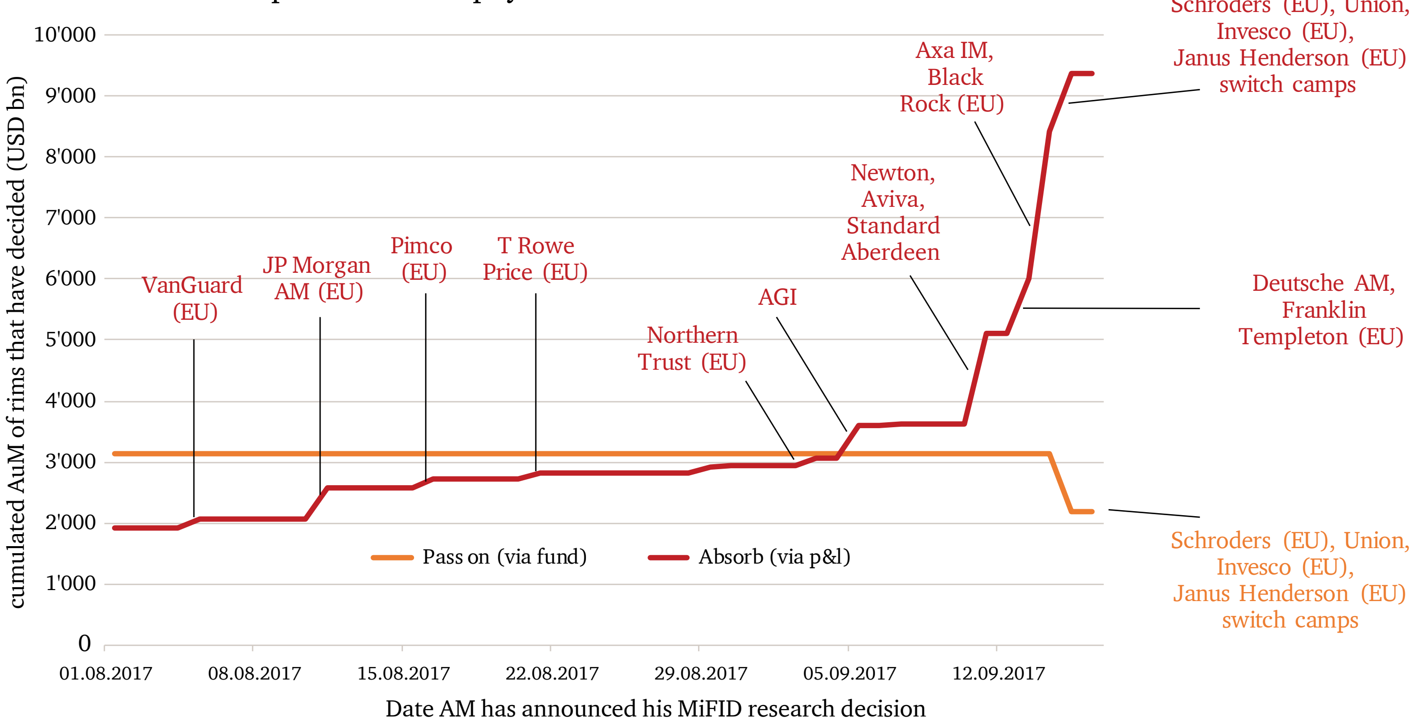
Until recently, compliance departments of investment managers were busy to figure out how they will pay for research. With that being settled now, the topic of "Corporate Access" is moving up on the agenda. The most critical question in that respect is if "free" corporate access provided by brokers is considered an inducement under MiFID 2. We think the answer to that is quite straightforward: yes, in the vast majority of cases it is an inducement and systematically accepting free meetings from brokers is not compliant with MiFID 2. In the mid-term we expect issuers will be facing make-or-buy decisions, i.e. either organise investor interactions on their own or source these services externally. Both solutions will require higher budgets for IR departments, which might be partially compensated by the clever use of software and improved processes.

The industry has decided on the MiFID 2 research payment model: "Absorb" wins.

Under MiFID 2, asset managers have two options for how to pay for third-party research. They can continue to charge such costs to the fund, even if this will require new processes to be set up to ensure increased transparency and compliance. Let's call this the "Pass-on" model. Or, they can pay via their own P&L, thus impacting margins, unless fees are increased. We will call this the "Absorb" model.

As the chart shows, already at the end of this summer, international heavyweight asset managers announced their decision to pay for third-party research cost via their own P&L. In early September then Schroders, Union and Janus Henderson – all previously in the "Pass-on" camp – announced that they will apply the "Absorb" model as well.

MiFID 2: How European AMs will pay for research



Source: Interaction Partners

And while the "Pass-on" camp still includes some illustrious names like Carmignac, Amundi,Fidelity and Deka, we think "Absorb" has de facto become the industry standard. Not the least as it will be quite a marketing nightmare to explain why your clients have to pay extra for research while that service is included with all your major competitors.

While Switzerland is not directly subject to MiFID 2, the situation looks similar. The vast majority of large asset managers, including key players such as Credit Suisse, UBS, GAM, Lombard Odier, and Pictet (as recently as in November) have opted for "Absorb". Also smaller players like Vontobel, Bellevue, LLB, VP Bank have stated that they will pay for third-party research out of their own P&L, as the FuW has reported.

If research costs are "absorbed", so will costs for corporate access.

There was some uncertainty if corporate access can be considered research and therefore be charged to the fund, e.g. via a Commission Sharing Agreement (CSA). The French regulator (AMF) for example advocated a quite broker-friendly approach. This interpretation however is completely at odds with the FCA, UK's regulator. The latter in its July "Final Policy Statement on the Implementation of MiFID 2" clarified that corporate access services under MiFID 2 are not regarded as research and therefore cannot be paid directly via the fund through Commission Sharing Agreements or Research Payment Accounts (RPA).

That discussion however has now become redundant. If an investment manager has opted for the "Absorb" model for third-party research, she/he will apply the same model to corporate access. Or, to put it differently, paying for corporate access out of the investment manager's own P&L has become the de facto industry standard by now.

Accepting "free" corporate access from brokers is not a work-around but an inducement.

Some market participants happy with the status quo are now considering to provide and accept corporate access for "free", obviously with the idea of compensating for this with other business. This, however, is not only violating the principle of transparency which is at the core of MiFID 2, but is also at odds with the actual implementation of the regulation in most countries and ultimately companies.

In the big picture of Article 24 of MiFID 2, inducements are defined as payments or benefits received or provided by an investment firm which give rise to conflicts with the firm's duties to act honestly, professionally and fairly in accordance to its clients' best interests. As a consequence, the Delegated Directive makes clear that inducements must not be accepted by asset managers if they result in the provision of investment services to the clients being biased. With respect to corporate access, the ESMA Q&A states that, for example, a clear case of inducement may arise during individual meetings or field trips with corporates, which inevitably involve the allocation of valuable resources by the provider (i.e. a broker) and have a value to the recipient (i.e. the investment firm) which is not minor in nature and could influence the investment behaviour.

The French regulator AMF (Autorité des Marchés Financiers) however affirmed that "free" corporate access services could still be provided in the form of so-called concierge services.
That is, the broker organises meetings between asset managers and corporates, independent of its research services. This way, the AMF believes that only a minor-non-monetary benefit (MNMB) is provided to the investment firm – thus it being a de facto exception from the inducement rule. This only applies to France.

Contrarily, the UK regulator FCA (Financial Conduct Authority) argues that concierge services can be provided but for a cost at commercial level. In other words, asset managers have to pay a fair fee for each individual meeting or roadshow that is organised by the brokers.

At the micro-regulatory level, since MiFID 2 places the onus to decide whether "free" corporate access is an MNMB or a benefit directly on each investment firm, their own internal compliance departments will have to adjust their framework to embrace the new regulation by January 3, 2018.

We expect most investment firms across Europe (including Switzerland) to adjust to the FCA viewpoint as it is the "toughest" and widely used financial regulatory standard. We also think that the following two arguments need to and will be considered as well.

Top-down: in the past – and larger asset managers might have a look at their own broker votings for this – approximately one third of commissions paid have been allocated on the basis of corporate access. For the United States, in 2016 the Wall Street Journal put a USD 2bn price tag on these services. The figure for Switzerland will be much smaller, we estimate ~ CHF 30m. Still labelling corporate access an MNMB without a proper explanation seems difficult to us.

Bottom-up: organising a roadshow or a conference is not that easy. The costs for a single meeting on a roadshow, organised efficiently, plus software supported for the UK are estimated to be ~ GBP 500. We think the fully-loaded costs of a meeting for a broker-sponsored roadshow are even higher. Nevertheless, let's assume the compliance manager might be convinced the "value" of such a meeting is GBP 200. Considering this to be an MNMB still has to fit in the overall compliance framework of the respective firm. With most investment managers nowadays having e.g. very strict "gift policies" in place that forbid the acceptance of even minor gifts and put a EUR 100 cap on lunch invitation, we think labelling "free corporate access" an MNMB will be quite a stretch.

On this occasion a side remark for smaller Swiss investments firms: clearly, their compliance manual can and should be less exhaustive and comprehensive than those of large international firms. Still, they should not treat this lightly, too, even if they have no EU clients. Simply using EUREX options for hedging purposes will require them to comply with MiFID 2 rules.

Investors are ready to pay brokers for corporate access, but much less than in the past.

Over the last months, and in particular since the FCA Final Policy Paper has been published in July, our discussions with asset managers are indicating the willingness of the investment community to pay for corporate access, be it in the form of roadshows or conferences.

Investors are willing to pay for the efficiency and convenience of conferences, even via their own P&L. Their willingness to pay however does not seem to match the amounts that in the past have been paid out of the fund via trading fees.

The willingness to pay for roadshows, especially for smaller companies and "investor relations only" roadshows, appears to be very limited, to say the least.

Conferences: might even gain in importance, but with more modest locations.

In this light, the era of "spa retreats" and fancy hotels for conferences seems to have come to an end as well since the buy-side will have to pay for participation out of their own P&L. In our view, although the conference model will still be active under MiFID 2 and might even gain in importance, we expect that locations will get less impressive and that corporates will have to pay for participation as well. This seems especially true in the case of smaller companies where the "pay to play" model for conferences has gained substantial momentum over the last 24 months.

Roadshows: outlook more messy, mid-term corporates are facing make-or-buy decision.

For roadshows the outlook is a little bit more messy. Generally speaking, we expect the number of roadshows to be going down, but not massively.

Below we have described three scenarios of how investor access via roadshows might play out.

1

Continuation of status quo

AMs generally use P&L to pay for corporate access via the brokers and the status quo for corporates continues, i.e., the concept of broker-sponsored roadshows will remain the standard approach.

Unlikely

2

Co-organised roadshows

Brokers will offer "sponsored roadshows", but corporates will have to address a large number of investors on their own, be it by filling part of the roadshows schedule or separately (site visits).

Direct meeting requests from investors reaching out to corporates increase materially.

Most likely short-term

3

Make-or-buy

The concept of "broker-sponsored roadshow" gradually fades. Corporates will then have to decide if they organise roadshows on their own or rely on external providers (which might be brokers too).

Most likely mid-term

Contacts

PwC
Birchstrasse 160
8050 Zurich
Switzerland

Dr. Günther Dobrauz
Partner, Leader PwC Legal Switzerland
Office: +41 58 792 14 97
Mobile: +41 79 894 58 73
guenther.dobrauz@ch.pwc.com

Michael Taschner
Senior Manager, PwC Legal,
FS Regulatory & Compliance Services
Office: +41 58 792 10 87
Mobile: +41 79 775 95 53
michael.taschner@ch.pwc.com

Orkan Sahin
Assistant Manager, PwC Legal,
FS Regulatory & Compliance Services
Office: +41 58 792 19 94
Mobile: +41 79 238 65 69
orkan.sahin@ch.pwc.com

Interaction Partners AG
Nüschelerstrasse 35
8001 Zurich
Switzerland
+41 44 585 35 20
www.interactionpartners.ch

Dr. Kilian Maier
CFA – Co-Founder & CEO
kilian.maier@interactionpartners.ch

Luigi Bruno
LL.M. – Director
luigi.bruno@interactionpartners.ch

The scenario of **"continuation of status quo"** is the most unlikely one in our view. We understand that it still has quite some followers, but except for its intellectual simplicity it does not have many attractions. The most frequently heard argument for "status quo" is that brokers will find a way around it, as they have in the past. Considering the increased power of regulators and compliance departments we are, however, not sure if this works out this time as well. Or, if – in the light of banking's tarnished reputation – this would be a good idea in the first place. Against "status quo" speaks the willingness of investors to pay out of their own pocket, which in our view is just not broad and deep enough to allow for a continuation of broker-sponsored roadshows.

Short-term we might see **"co-organised roadshows",** i.e., the broker invites all those asset managers that have agreed to pay him. Investors that do not have such an agreement in place with the broker will not be able to accept "free meetings". That means the issuer will have to add those investors on his/her own. In practical terms it will be quite a logistical challenge: several parties from different organisations on different platforms with different targets (serve broker clients vs find best investors for issuers) working on the same schedule does not sound like a recipe for a smooth process.

Mid-term we expect issuers to take over more control over the process, which in the end will require **"make-or-buy"** decisions. On the one hand, by opting for "make", IR departments will need more manpower, as well as resources, to cope with direct meeting requests and to organise roadshows on their own. On the other hand, the "buy" option will require corporates to reach out to external providers – be it brokers or independent service providers – in order to organise roadshows, conferences and most likely cope with the sharp increase in direct meeting request from asset managers. Under both scenarios, a materially higher budget for investor relations will be required, which can partially be mediated by the clever use of software, processes and providers, tailored to the situation and strategic priorities of the issuer.