Mifid II

Impact to date and long-term consequences

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WHAT IS MIFID II

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- **Mifid II:** an EU-wide law that, among other things, made banks/brokers charge investors for the research they provide, rather than bundling the costs into commissions for trading.
- Became effective in January 2018.
- Mifid II applies to the 31 countries of the European Economic Area (EEA), which comprises the 28 EU members plus Iceland, Liechtenstein, and Norway.
- The new regulation applies directly to financial-market players that are based in any of the EEA member states as well as to a European branch location of any company headquartered outside of the EEA.
    - Impact seems to extend well beyond Europe.

- Large academic literature on sell-side recommendations shows existence of substantial abnormal returns to recommendation revisions or revision-based strategies.
- Anderson, Jones, and Martinez (2019, JFQA) perform a very detailed study for Sweden.
  - Measure abnormal profits as the product of the daily net trades of the recommending brokers' clients in the recommended stock and the abnormal return of the recommended stock. I.e., they control for whether stocks are investable.
  - Main findings:
    - Half of the abnormal profits in their analysis are made before the recommendation is released.
    - Find that the clients of recommending brokers profit from upgrades but not downgrades.
    - Abnormal profits to both upgrades and downgrades of small caps are negligible, despite the large abnormal returns to these recommendation changes.
    - Recommending brokers capture 40% to 60% of the value of the profits made by their clients through extra commission revenues.

- From a firm's perspective, is it important to be covered by sell-side analysts?
  - Kelly and Ljungqvist (2012):
    - On announcement that a stock has lost all coverage, share prices fall, on average, by 110 basis points.
    - Reductions in coverage are followed by **less efficient pricing** and **lower liquidity**, **greater earnings surprises** (so higher forecast errors), **more volatile trading** around subsequent earnings announcements, **increases in required returns**, and **reduced return volatility** → the information environment of those firms that lose coverage suffers.

- Other aspects of sell-side research:
  - In a survey of 344 buy-side analysts from 181 investment firms, Brown et al. (2016) find that sell-side analysts are important for buy-side analysts for two main reasons: (1) **in-depth industry knowledge**, and (2) **access to company management** especially when the investment firm is smaller.

MOTIVATION FOR MIFID II

- The ban on “bundling” research with brokerage is targeted towards removing conflicts of interest that might harm investors.
  - Investment banks and brokerage houses’ might have interest in encouraging trading, which could bias their research.
  - Asset managers might not choose brokers in their clients’ best interest — the cheapest ones — when brokerage costs are both obscured by bundling and wrapped up with hard-to-price services such as access to top executives.
- Empirical evidence:
  - Ample evidence that issuing a recommendation increases trading in a recommended stock.
  - Karmaziene (2019, WP) documents that analysts' pay is based on the volume of commissions their recommendations generate for the brokerage house.
    - On average, an analyst is paid 78,000 Swedish krona more per year for research that generates a one standard deviation greater abnormal trading turnover for the brokerage house.

MOTIVATION FOR MIFID II

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- Mifid II also wants to increase transparency and reduce costs in asset management to increase household participation in financial markets.
  - A recent study for the European Commission found that the average first-year cost (entry and management fees) for an investment product in the EU is 4 per cent (the lowest of 1% for ETFs and the highest of 5.5% for equity funds).
  - Similar evidence exists for the US and other markets.
  - Costs of financial intermediation appear to be high and surprisingly stable over time (Philippon, 2015 AER).
  - Similar funds (even index funds) frequently charge very different fees (Cooper, Halling, Yang, 2019 WP).
  - What would be alternatives if we don't like the current system: (a) to introduce a cap on fund fees, (b) to educate (retail) investors more comprehensively, etc.

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- Given the short history little research is available. Implications are difficult to draw.
- Popular press: "Fund managers slash research budgets and trim their lists of external providers."
- Fang et al. (2019, working paper):
  - Look at a comprehensive sample of European firms.
  - Decrease in the number of sell-side analysts covering European firms after MiFID II implementation: 334 firms *completely lose* their analyst coverage (305 of those firms were only covered by one analyst the year before).
  - The remaining analysts are more likely to make sell or hold stock recommendations, their recommendation revisions garner greater market reactions, and their recommendations are more profitable.
  - Sell-side analysts seem to cater more to the buy-side after MiFID II by providing industry recommendations along with stock recommendations.

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- Some evidence on the impact on Swedish mutual funds (Froeberg and Halling, 2019 WP):
  - Study Sweden because the decoupling of research and execution costs has already been implemented since 2016 (i.e., we have 3 years of data to work with).
  - Pronounced decrease in research costs at the fund level in 2018, as many management companies internalize these costs.
  - Execution costs per trade seem to have decreased as well.

- Research paid for by the companies themselves: that might be worse than the original disease in terms of conflicts of interests.
- Sell-side analysts moving to the buy-side: seems reasonable in terms of conflicts of interests – production and use of research within the same entity.
  - Fang et al. (2019, working paper) show that buy-side investment firms turn to more in-house research after MiFID II implementation. Especially interesting, buy-side analysts increase their participation and engagement in earnings conference calls compared to the control group.
- Non-brokerage companies finding a profitable niche in providing it:
  - RSRCHXchange does not produce its own research, but operates as an online marketplace for around 400 brokers and boutique research providers to sell their reports to 1,200 fund managers that have signed up to the platform.

IS THE PRESSURE ON SELL-SIDE BAD?

- Maybe these developments are a feature, not a bug.
  - Conflicts of interest in the full-service brokerage model imply an inefficient transfer of rents from end investors to financial intermediaries.
  - If price transparency lowers demand, the most obvious explanation is that the research produced before was not worth the price → seems surprising given the academic evidence discussed earlier.
- Sell-side research becomes more restricted (including availability for academic research).
  - E.g.: UBS suspended research data feeds to data provider Bloomberg and other third-party platforms (including IBES).
- Finally, Fang et al. (2019) find some evidence that stock-market liquidity decreases post-MiFID II.

CONCLUSION

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- The original arguments – removal of conflicts of interests, increase in transparency, decrease of asset management costs – for Mifid II seem well justified.
- Mifid II seems to have a noticeable impact on the industry, especially on the provision of sell-side research.
- It seems to deliver on some goals (conflicts of interests, reduction of costs) but might also have unintended consequences (deterioration of market efficiency).
- The final assessment of the net effect on financial markets remains to be seen and needs more time and data.