Insight

U.S. – E.U. Conflict of Broker-Dealer Laws Hinders Important Equity Research

MEGHAN MILLOY | OCTOBER 18, 2017

In January, The Markets in Financial Instrument Directive II (MiFID II) from the European Securities Markets Authority will go into effect. Among its many provisions is one that requires broker-dealers to separate or "unbundle" the payments they receive for research expenses from those they receive for commissions. On its own, that doesn't seem like an overly-intrusive regulation. The problem is that the Securities and Exchange Commission (SEC) explicitly prohibits broker-dealers in the United States from receiving these payments unbundled unless they register as an investment adviser.

When the MiFID II goes into effect, U.S. broker-dealers will be unable to provide research to clients in the European Union or risk facing significant penalties from the SEC. This conflict of law not only hampers competitiveness of U.S. broker-dealers abroad, it also threatens the important production and sharing of equity research at home and abroad. Of course, as with most things, the more research in equity markets that is available, the better.

As a recent study from Edison explains so well, "[I]t is worth remembering the benefits that research brings to capital markets and why it is important an enduring solution is found. Equity research does play a vital role in capital markets through influence and enhancing: (1) Price formation and evaluation of the cost of capital; (2) New issuance and capital formation; and (3) Public/political awareness of the capital-market function globally."

Edison's study highlights the impact that good equity research has had on company growth, especially in the United States. For example, three of the largest 10 companies in the United States are less than 40 years old, whereas in France only three of the top 40 companies are less than 50 years old, with an average company age of 117 years old. This is largely due to the role that good equity research in the United States has played in helping investors to understand new industries and their characteristics. As Edison explains, "For investors to take the risk of investing in loss-making growth companies, research provides critical perspectives on the ultimate reward (market size/probability) that may balance the short-term risk."

Good equity research also serves to prevent market inefficiencies, specifically the misvaluation of particular equities. With good research at their disposal, investors are able to quickly understand an industry and its earning potential without having to do all of the leg work themselves. Research from New York University's Stern School of Business (Stern) estimated the value added by equity research analysts and found links between equity research, information efficiency, and asset prices. Stern found that when research coverage on a particular stock is dropped, share prices fall by 110 basis points or lose $8.4 million in value, on average. Further, they found that the drop in asset prices caused by a reduction in research is permanent, with no bounce back during the first month and performance "in line with risk and style benchmarks" over the subsequent six months to two years.

Thus, the importance of equity research cannot be overstated. The risks caused by the upcoming conflict of law between the SEC and the MiFID II are enormous. U.S. broker-dealers must be able to provide quality equity research to their clients in the European Union without facing devastating penalties in order to preserve their competitiveness and the productivity of U.S. capital markets. According to a Bloomberg article on the matter, "the SEC is expected to announce its intention to issue no-action letters to allay the conflict by the end of the month," although it had not confirmed with the SEC directly. The SEC should follow through and issue such no-action letters to allow U.S. capital markets and the flow of equity research to continue to function effectively and efficiently.