Breaking free of the broker model

Michael Hufton asks what the FCA's Wholesale Competition Review means for IR – and why it matters

In today's increasingly developed and interconnected capital markets, it's striking how much IR practices differ. Why, for instance, do most big companies in Germany have well-resourced IR teams of six or more, with significant budgets, while the average FTSE 100 firm has a team of two or three and runs on a shoestring, when the importance of effective IR is widely recognized in both countries?

In the UK, the common refrain is that this reflects the role of the corporate broker. Every company has one – most have two – nominated corporate brokers. Smaller companies sometimes pay for the privilege, larger ones get the service for 'free'. Contrary to popular belief, there is no obligation to have a corporate broker; companies seem to continue having one just because they always have. The result is that a sizable portion of the IR job is outsourced to corporate brokers, and constrained team sizes and budgets are a direct consequence.

Nobody is under any illusion that this 'free' service comes at no cost, so how is it really being paid for? How much do lack of transparency, bundling, tying in and cross-subsidization raise barriers to entry for new players in the market or deter companies from switching between brokers and reduce incentives to innovate? Is client service as good as it should be? In the IPO process, do increasing syndicate sizes and research blackouts restrict independent voices by ensuring most of the market is 'inside the tent'? Can independents get access to management or to the deal prospectus in time to ensure contrasting views are available, helping with price discovery and with building a book of long-term shareholders?

Many corporates complain of being courted like the prettiest girl at the dance during the IPO process, only to be dumped during the honeymoon in favor of the next new listing. But if the payment mechanism is structured to provide large fees for transactions and none at all for the systems and services that underpin high-quality, longer-term interaction, is it any wonder that important, long-duration work is neglected? Over time we have let the industry adopt incentive structures that are misaligned with client needs.

CHALLENGING THE NORM

Questions like these are now being contemplated by the Wholesale Competition Review instigated by UK regulator the Financial Conduct Authority (FCA). Are there structural impediments to effective competition and innovation? Does lack of change reflect inertia? Are things as they are because clients are happy the system works in their best interests and provides value for money? If there are impediments, does it matter? And if so, what can be done about it?

There is a growing awareness of the inherent conflicts of interest in the integrated investment banking model. Brokers and investment banks act for corporates on a nominally unpaid basis but are remunerated via transaction fees. They also act for institutional investor clients that pay via commissions, commission-sharing agreement payments, custody and stock lending fees, principal trades and structured products, to name but a few.

Multiple interactions and payment flows take place at many levels, making it near impossible for either side to be sure how much is being paid, and for what. Take arranging a meeting between a company

At a glance

THE BROKER MODEL

In the UK, relatively small investor relations teams reflect the role performed by the corporate broker. Every company has at least one nominated corporate brokers and a sizable portion of the IR job is outsourced to them.

INVESTIGATING MARKETS

The UK's Financial Conduct Authority is investigating this model and reviewing the investment and corporate broking sector. The outcome of its Wholesale Competition Review, due at the end of 2015, coupled with mandatory unbundling to be introduced by MiFID II, will affect IR.

THE IMPACT FOR IR

Depending on the outcome of the review, changes could mean an increase in the insourcing of services currently carried out by corporate brokers. Investor relations budgets will have to rise, choice and quality will increase and innovation will flourish.

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and investors, for example: who is the intermediary working for and what are the incentives? Indeed, what does acting in the client's best interest *mean*?

For all the buzz surrounding financial technology, a great deal of manual intermediation remains in many areas of financial services, where practices have hardly changed for decades. Elimination of routine administrative processes as a result of well-designed technology simultaneously enables efficiency gains and elimination of conflict. Machines can send encrypted, sensitive data directly between customers; this was previously manually intermediated. It means not only a better flow of information at lower cost, with proper record keeping and reporting, but also improvement in quality because confidentiality can be assured.

COST OF CHANGE

A good example is post-roadshow feedback, which is woefully inadequate in the current system – bland, filtered, even fabricated – and investors frequently can't or won't give it as they worry how it may be misused. Secure technology can improve this process by enabling quick, direct, confidential, real-time feedback between the two parties. This makes the engagement better, fulfills stewardship obligations and provides much better-quality management information to each side. In short, harnessing modern technology means we can do a better job more cheaply, to the benefit of the end-client.

Delivering this sort of innovation and improvement to the marketplace is almost impossible if there is an existing 'free' offer. Even if the existing service is flawed, it's tough competing with anything free, especially if it has contributed to IR budgets being artificially constrained. Clients getting a sub-standard service find themselves locked in. That's why it's a real competition issue and the regulator is right to examine it in depth.

Fair and effective competition is good for all participants. It ensures a fair deal for clients, encourages innovation and efficiency, and keeps incumbents on their toes. A common misconception is that new practices and disruptive technologies mean the disruption of incumbents. What it actually means is the disruption of inefficient, outdated ways of doing things. Incumbents are equally capable of innovating to deliver better products and services. The airline industry provides an interesting example: the advent of low-cost airlines, internet sales, online check-in and electronic boarding passes has delivered massive benefits to passengers and the old oligopolistic flag carriers have had to up their game.

We won't know the outcome of the FCA's Wholesale Competition Review until the turn of the year. But if it recommends action to improve price transparency and eliminate cross-subsidization, bolstering the mandatory unbundling to be introduced by MiFID II, this will be a bonus for IR. It will increase insourcing of services currently carried out by corporate brokers. IR budgets will have to rise; choice and quality will increase; innovation will flourish. New tools will lead to better direct interaction between investors and corporates and, as a result, better information flowing back to boards and management. IROs will perform their crucial role as management's eyes and ears in the market.

ESSENTIAL ENFORCEMENT

A critical element will be enforcement. Since April 2015, the FCA has had the power to order cessation of activity or fine a company up to 30 percent of global turnover in a relevant market. The regulator knows the importance of enforcing its rulebook: changes introduced in 2014 to regulations surrounding corporate access in the UK market have not been enforced, with the result that rules are widely ignored and openly flouted.

Expending energy introducing new rules that are not enforced is counter-productive; it undermines the integrity of the market and the reputation of the regulator. That said, there is little point enforcing rules that are about to be superseded – explaining the lack of action to date. After the Europe-wide adoption of MiFID II – currently set for January 2017 – enforcement should pick up.

We are heading for the biggest changes the UK has seen since Big Bang in 1986. That change heralded the era of the integrated investment bank and hastened the end of stockbrokers as unlimited liability partnerships – and is now widely seen as a mistake. The UK has been leading the current regulatory changes but continental Europe is following and the rest of the world is watching closely.

The changes will introduce new systems and new ways of doing things, and these new methods will be open to all. Incumbents will be able to embrace change and thrive. If we get this right, the rest of the world will follow. And we must get it right: failure could result in the pensions problem ballooning into a new financial crisis – one big enough to break the entire system. It's going to be an exciting time.

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