For Regulators, Intentions Don't Equal Outcomes

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I'm not a great fan of regulation for regulation's sake. While this is too strong and cursory a judgment on what has been happening in the US and Europe for the past few years, some suggested regulatory changes make you wonder.

For instance, recent proposals from European Securities and Markets Authority (ESMA) and the U.K.-based Financial Conduct Authority (FCA) are of particular concern. While the regulations being introduced aim to protect investors by shining a light on the fees paid by asset management for research, the abolition of 'soft dollars' is likely to have the opposite effect of that intended. Prices for asset management firms will rise and the cost will surely be passed on to the individual investor. And furthermore, it is not clear the problem the regulators are trying to solve is in fact a problem.

It's similar to the rules around mandatory electronic trading of over-the-counter derivatives in the U.S. The Dodd-Frank Act was meant to open up the playing field, introduce competition and deliver a more transparent, centralized marketplace for investors. Instead, Greenwich Associates research has shown the trading flows are concentrating even further through top dealers while liquidity is fragmenting into regional pockets.

Back to equities. While the growth in e-trading in the European equity markets has lagged behind the U.S., the tide is turning with investors expecting to execute 37% of their trading volume via electronic channels by 2017. This is driving down execution costs and sapping commissions in the process. Best execution and algorithmic trading in the equities markets are also benefiting investors in the short-term, but there is a real danger that constrained revenue from cash equities will continue to hobble brokers' efforts to enhance their services. Long-term this is not good for the industry.

Increased regulatory scrutiny from ESMA and the FCA is compounding the negative effects of e-trading. In late 2013, ESMA led efforts to place caps on trading in dark pools in single venues, and across EU exchanges in hopes of fostering more transparency in the European markets. 58% of traders participating in a Greenwich Associates survey strongly oppose the dark pool trading-cap rules, suggesting that the caps will reduce efficiency and liquidity – leading to higher costs.

In addition to the tightening of trading regulations, the FCA, and subsequently ESMA, is aiming to delineate how asset managers can leverage client funds. In a consultation paper from November 2013, with clarifications from May 2014, the FCA outlined the need for the buy-side to use client funds for substantive research – buy/sell/hold recommendations and projections based on analytical data. Although this may seem to best serve the managers' clients, the reality is that equity research and advisory services are crucial to maintaining market equilibrium.

The latest Greenwich Associates European Equity Investors research shows that 54% of the commissions wallet, an estimated €1.47 billion, is allocated to research and advisory services. With commissions suppressed by dark pool trading caps and the growing phases of e-trading, the buy-side is left with few options to aggregate the necessary market intelligence:

- Take on these costs directly, lowering profitability
- Bring research capabilities in-house, increasing costs
- Be priced out of the market by competitors willing to meet increasing sell-side price tags

Any of these options will inevitably affect the end investors. Whether their fees rise to new heights, returns suffer from lack of information, or they are phased out of the market, the goals of the FCA and ESMA won't be met. Investors will suffer, while the buy-side and sell-side scramble to adjust to a new environment. Regulators need to consider the holistic impact of action, before disrupting the markets with the next big splash.

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