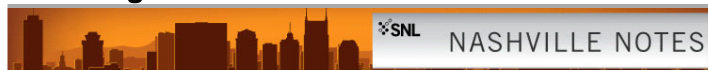
SNL Blogs



Tuesday, December 10, 2013 5:00 AM CT

Another Volcker rule may loom for equity capital market units

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

Regulators will adopt the Volcker rule this week, which will preclude proprietary trading by banks in a massive tome that describes what is and is not permissible. That regulators who have never sat on a trading desk (or on a credit committee to approve loans) will define what constitutes proprietary trading versus market making and inventory management to facilitate customer order flow seems absurd to me. Like other Dodd-Frank mandates and never-ending litigation, the rule is another cost to the banks for the Fed and Washington rescuing the banking system in 2008 and 2009. My bet is that Volcker will suck liquidity from the market, but it will not be too noticeable until the next crisis or bear market develops.

Within Wall Street's equity capital market operations, another Volcker-like rule may be in the making. In the U.K., the Financial Conduct Authority (FCA) is in the process of ratcheting up the pressure on asset managers to steer clear of soft-dollar arrangements that allow managers to pay for services provided by brokers with commission dollars. One of the key services is "corporate access" in which the sell-side arranges for the buy-side to meet with company management, industry leaders and sometimes government officials. Usually this involves sell-side analysts traveling with management to the buy-siders' office, buy-siders traveling with the sell-side analyst to visit management's office, or arranging meetings at dinners and conferences. I once heard it described as a sell-side concierge service. It was not a bad description given the logistics, including coordinating car services, catering, hotels and obtaining private jet tail numbers.

In a Dec. 2 post, Skadden Arps Slate Meagher & Flom LLP noted: "The FCA believes the asset managers have 'pushed the envelope' and stretched the definition of investment research to include payments to brokers to facilitate access to directors and senior managers of issuers (corporate access)." Skadden goes on to opine that asset managers will have to unbundle substantive research from non-substantive research — i.e., asset managers will be banned from paying for corporate access with dealing (soft) commissions. Integrity Research Associates, commenting on the same subject, stated, "The FSA is adamant that corporate access does not meet its definition of research and is therefore ineligible for payment with client commissions."

As every sell-side analyst, research director, salesman and trader knows, corporate access has become very important in determining how commissions are allocated by the buy-side. Integrity Research Associates cites Greenwich Associates as stating that 30% of U.S. research allocations by hedge funds in 2012 were for corporate access; long-only allocations were 19%. Integrity Research Associates cites a Thomson Reuters Extel survey that stated 38% of buy-siders considered corporate access very important when selecting research providers.

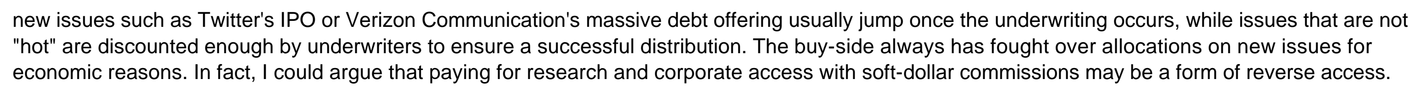
And institutional equity commissions remain under intense pressure as the sales/trading/research model struggles with lower revenues in what is a thin-margin business. According to a June 27, 2013, release by Greenwich Associates, U.S. institutional equity commissions declined from $14.0 billion in the 12 months ended March 31, 2009, to $9.3 billion in the 12 months ended March 31, 2013. On an annual basis, the drop has been steady with a 15% reduction from 2012. The reduction in commissions paid for research may not quite match the aggregate drop because research allocations approximate 55%-60% of commissions, according to Greenwich Associates. The balance is for execution.

In an age when the SEC is investigating JPMorgan Chase & Co. for the longtime corporate practice of hiring children of executives for internships that it sought business, it seems like corporate access could easily find its way to the SEC's and/or FINRA's agenda as it has in the U.K. In addition to questions raised about paying for access with customer's commissions that the buy-side could (and does) arrange for itself, corporate access raises questions about sell-side independence. Analysts and firms with negative views on a particular company are not usually asked to arrange buy-side meetings, and a lack of meetings has negative implications for commission allocations. It seems like another Volcker-type rule could eventually flow from corporate access.

In a post earlier this year, Integrity Research asked: How long will investment banks subsidize research (and equity sales and trading)? Integrity's question is a good one. My view is that the sell-side ramped up its use of corporate access to drive institutional commission allocations once the 2002 Global Settlement prohibited research to be directly compensated by investment banking. If the U.S. follows the U.K. and bans the use of commissions to pay for corporate access, then the subsidy will have to increase, or research (and sales and trading) will have to contract further. Integrity also wonders if the FCA will try to abolish the payment of research with client commissions in a truly unbundled (U.K.) world where the asset manager writes the check.

Cash equities, unlike M&A and capital-raising conducted by investment banking, is a thin-margin business. Banks that can afford to do so have a good reason to maintain some level of subsidy because research indirectly helps investment banking by covering existing and potential underwriting and M&A clients.

And it is a two-way street even if the U.S. follows the U.K. and bans the payment of corporate access with commissions. I believe the buy-side always will be inclined to pay likes of JPMorgan Chase & Co., Morgan Stanley, Goldman Sachs Group Inc., Citigroup Inc. and Bank of America Corp. because these institutions lead the league tables in underwriting. Payment can always be justified based upon best execution, even (I think) in a post-Volcker world. Hot



new issues such as Twitter's IPO or Verizon Communication's massive debt offering usually jump once the underwriting occurs, while issues that are not "hot" are discounted enough by underwriters to ensure a successful distribution. The buy-side always has fought over allocations on new issues for economic reasons. In fact, I could argue that paying for research and corporate access with soft-dollar commissions may be a form of reverse access.

Published with permission.

Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial.
He can be reached at jeffdavis@mercercapital.com or 615.345.0350.