MiFID II

Muddlehead madness

22 January, 2018

From January 3 2018, the date from which Financial Conduct Authority's Muddlehead 2 (aka MiFID II) came into play, the world has changed for quoted companies, small caps especially. Now, if companies want to maintain stock market ratings that will enable them to raise funds, they need to apply their marketing skills to their company's equity and debt as determinedly as they market their goods and services.

In effect, the FCA has decreed that company chief executives now need to pay much greater attention to ensuring that their companies are understood - effectively becoming (if they aren't already) the marketing supremo for the product that is the company.

We call it **Muddlehead** because it is said to contain **1.5m paragraphs** and we have found no-one who understands it in its entirety, but the chilling effect has been to stop brokers sending out research. As a leading investment advisor wrote to us the other day:

'Historically I would guesstimate that I received circa 300 emails a day, of which circa 250 were probably research-related in some way. We were under instruction that from MiFID2 D-Day on 3rd January we were not to receive any unpaid research work and must refer any questions in this regard to our compliance department. From 3rd January the only pure research article I believe that I received was from Equity Development, which I referred to compliance and who responded and confirmed that it was okay to continue to receive. Well done for navigating the ruling so successfully!'

A highly successful and respected investors' maven, the blogger Paul Scott, summed up as follows:

'Broker research, especially on smaller caps, now seems to be reducing considerably, and access to it is being greatly restricted by MiFID II*…..It's the main content (narrative) & forecasts of broker research which are the important, useful bits, which often inform & educate on a company's operations, and sector. We can tweak their numbers to arrive at more cautious forecasts ourselves, which is easy enough to do.'*

The lesson, as we have long believed, is to provide good, sound research. That's what the market craves, not spin.

We are pleased with the spirit behind the FCA's behemoth because it forces transparency and that was at the root of our thinking when we started ED. In a way MiFID has just caught up.

Sadly, though, it's a dog's dinner of regulation that puts all the fund-raising power in the hands of the big banks and, even though it helps us as independent paid-for research providers, we detest it for what it does to **the vital Smaller Quoted Company (SQC) sector.**

AIM All Share (AXX)

January 1 – December 31 2017

Source: ADVFN

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January 1 2015— December 31 2017

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Author: Brian Basham

Please refer to the important disclosures shown on the back page and note that post MiFID this information is categorised as Marketing Material

Smaller quoted companies

SQCs are, or should be, the pinnacle of the small company world that is itself the backbone of the economy. Small companies represent 99.9% of businesses, they drive growth, open new markets and create jobs. As seedbeds for innovation, they encourage competition and bring fresh ideas that challenge the status quo. They also employ over 24.3 million people, a massive 81% of the overall workforce.

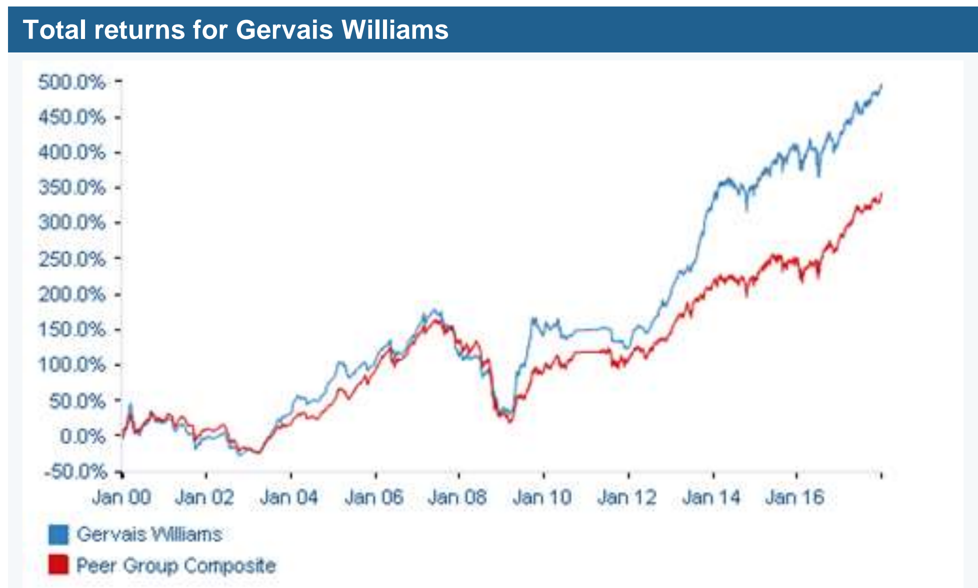
There was a colossal **47% increase** in the number of small business births between 2009 and 2013, which coincides with the UK's economic recovery after the 2008 bank induced crash. It appears, therefore, that SMEs have played a vital role in lifting the UK out of recession and our continuing economic growth depends upon them. However, it is estimated that 55% of small and medium-sized enterprises don't survive more than five years with circa two thirds of small business owners admitting that it is difficult to grow their firms.

SQCs are the top the small company tree and they have survived, not only commercially but also intense scrutiny - by lawyers, by accountants, by finance houses, by investors and either directly by the exchange on which they are quoted or by its officers. Now, just when we need SQCs most to survive and thrive, they have been sabotaged by Muddlehead.

They are particularly vulnerable because **individual investors now dominate the SQC sector** (see *'Magic or Mushrooms?'* later) and, despite the handsome returns that are to be had, all but a few institutions have abandoned the sector, primarily because the sector is **already** under-researched.

At least one fund manager has leaped on that as a major opportunity. The spectacularly successful boss of Miton Group, Gervais Williams - see chart below - prowls the SQC market precisely because the shares *are* **under researched and, therefore, are undervalued**. He happily invests in what he calls 'ant companies', those well below the sightline of his competitors because that's where he find value that other have missed.

Total returns for Gervais Williams



Source: TrustNet

To us, the lesson of that is to ensure that good research is available, backed up by sensible marketing. In that respect, as the MiFID II door closes, the social media door opens: in that it has never been easier to talk to investors directly and to physically show them a company's operations.

That is important because many traders, including institutions, are attracted by the 'momentum' of a share price: if it's going up, they buy more; if it's falling they sell.

It all boils down to a two simple facts**: First, try to ensure that your company's share price reflects the company's prospects, not just its present day value and secondly, remember that to achieve that, for most SQC's, means marketing to private investors much as they would sell to retail customers anywhere.**

It's a new budget item for sure, but the rewards for success can be great and the price of failure threatening. Clear messages are key, through respected research (and flatulent puff pieces do more harm than good), a consistent, message through Annual Reports, through all statements and the full gamut of social media from web seminars (webinars), to Facebook, text, Instagram, twitter et al.

And don't forget the trade press and local media! Many serious investors glean their best information from the trade press; as Gervais Williams points out, locally well informed private investors can have an advantage even over experts like him - '*that fleet of trucks look smart', 'have you seen that Harrisons are employing hand over fist',* or in 1903 in Birkenhead Open Market *'have you seen that new Penny Bazaar?',* later to change its name to *Marks and Spencer*.

It adds up to using a well-constructed, comprehensive marketing programme. We're good at it and if we can help please get in touch.

Napoleon's chaos

Napoleon I might or might not have said that Britain was a '*une nation de boutiquiers'* and he might or might not have pinched the phrase from Adam Smith's *Wealth of Nations* but it's certainly true that our latter day Napoleon, Andrew Bailey, CEO of the Financial Chaos Authority, has well and truly stuffed the SQC nation of 'shopkeepers' with his ridiculous 1.5m or so paragraph MiFID II regulation.

It's a shame because, until now the Conservative government has been doing well where smaller companies are concerned:

- They've set put the Regional Growth Fund (RGF) where businesses looking for funding of less than £1 million, can apply for support through Regional Growth Fund programmes; since 2011, £1.7 billion has been allocated to more than 9,400 small and medium-sized businesses;
- have introduced loans, mentoring and support for sub one year old start-ups or very small, early-stage businesses who the banks won't touch.

  The average loan is around £6,000; Small business can obtain loans from the UK government, the Scottish Parliament, the Welsh Assembly and the Northern Ireland Assembly;
- they help through UK Export Finance by 'underwriting' bank loans;

- they've allocated £1.2 billion to ' non-traditional fund managers and lenders' through the Business Finance Partnership and they made promises in the Conservative election manifesto on tax (simplification and lower corporation tax); business rates (review and self-assessment);
- and with the disaster that is Carillon fresh in our minds, some poignant commitment such as 33% of central government purchasing to come from SMEs by the end of the parliament; big government contractors to pay their bills promptly; better protection for the self-employed and workers in the 'gig economy'; help for digital businesses and better access to digital infrastructure and the usual rises on Brexit.

Full marks to them for all that, but now Bailey has promoted the stifling Muddlehead 2 that looks to be set to strip investors of research information on those very hero smaller companies that *have* achieved a stock market quote, and the access to development capital that implies.

Muddlehead seems an astonishing misapplication of resources given that not one single senior director of the banks that caused the 2008 crash has been arrested, either in the UK or the US. It can't be lack of resources because the cost of producing MiFID II must have been enormous, so it can only have been either lack of will or fear of the power of the banks within the economy and as political funders. In so thoroughly bludgeoning an investment sector that has been no threat to the economy, whilst letting senior banker off scot-free, we can't help but think that the FCA has got its priorities wildly wrong. It all adds up to growing support for the FCA being branded the Financial Chaos Authority.

And we're not alone in voicing our concern. **The Financial Times** reported recently that:

'The president of Japan's biggest investment bank Nomura Holdings has signalled a shake-up of the company's research operations at home and in the US as it braces for the realities of sweeping EU regulatory reforms that came into force at the start of the year. In an interview with the Financial Times, Koji Nagai laid out the challenges posed by new Mifid II reforms and the forced unbundling of research and equity sales, saying that Nomura was "not a charity" and could not produce research free of charge.'

In an excoriating article in **the Independent**, under the headline '*How the big banks are making a mockery of a genuine attempt to reform financial services'* the respected veteran financial journalist **Chris Blackhurst** wrote:

'The end result of MiFID II...will be one of damage to the investment industry'. His verdict was that: the large banks are... keen to build market share, to hog the market, to price out of the industry the smaller players that do not have their vast resources….

Sensing an opportunity to grow their business, and sniffing blood, the giant banks have moved, slashing their prices to shore up the relationships with the funds and the owning groups, something that can yield all sorts of spin-offs across the investment banking spectrum of activities, and at the same time to drive the competition out of the market.'

As a result, Blackhurst predicts: ***'Stocks will not be analysed or if they are, the scrutiny will be done badly.*** *Plus, their fierce price-lowering approach is bound to damage revenues at the smaller firms – the second tier banks, small-cap stockbrokers and independent research houses. That can only result in a reduction to their services or their disappearance*

completely. ***That means loss of analysts' jobs and less coverage of stocks – something that will only harm the investor.'***

Sadly, we think that the big banks do welcome over-kill regulation. They know that it hog-ties those small businesses that might grow to become competitors. The giants know that they can employ grunts by the barrow load to navigate the regulatory maze, leaving the movers and shakers free to make money.

When it comes to small companies, the burden of regulation usually falls on the CEO or FD and that inhibits the growth of the business. Just look at another business we were involved in: **ArchOver**. Regulation tied up the CEO, Angus Dent, for months. Now that it's an established business, regulation is a barrier to entry for potential competitors.

As for the Government's much vaunted support for 'challenger' banks and sources of finance, forget it. Crushing regulation will ensure that it won't happen.

Compare investment over-regulation with gambling free for all

The whole regulatory environment has become a stitch-up that is all the more unfair when you consider the comparison with the gambling sector:

If we wanted to punt £10k on a horse, I'm sure I could find a taker no questions asked. The law accepts our right to take that risk with my money. If we want to do the same with a small company, we have to jump through all sorts of suitability and KYC hoops – we're told that the broker Rathbones are even subjecting clients to psychometric testing, primarily and wisely, we suspect, to protect their back from the FCA.

There is no regard in the gambling scenario paid to the resources available to the 'punter' to make a sound judgement and that's as it should be. It's called freedom.

Of course, punters, investors, call them what you will, need to be educated and there's a minority out there of idiots indulging in gambling, investing, drugs, drink even over-eating but it's always wrong to regulate the system to accommodate the lowest denominator. Investment stands alongside drug abuse as the only sectors where it happens.

Just compare the decision making processes between betting on the horses and investment and ask yourself where is the justice in investment being regulated out of sight and gambling being almost completely unfettered?

In both gambling on the horses and small company investment, the punter has his or her residual knowledge to rely upon. In the initial assessment, the processes are remarkably similar. For a horse, the punter might look at bloodstock line, the trainer, the jockey, the form of the other horses, the 'going'; soft, hard etc and media views.

In the case of a company the punter can also look to the 'bloodstock line', as represented by the record of the principal promoter of the company; he or she can assess the reputation of the jockey, or CEO and can look deeply into the success or failure of other companies supported by the brokers to the business.

Finally an assessment can readily be made of the company's competitive position and the state of the sector, loosely, the going. Media views can also be an invaluable guide in both cases.

But there the comparison ends. The only documentation available to the racing punter are publications like Timeform, which is totally unregulated and is even owned by a bookmaker, Paddy Power Betfair! Contrast that with a public company, where even the most lightly regulated exchanges insist on companies providing a mass of information and where all companies are subject to the Companies Acts.

As a result, compared with horse racing punters, investors have oceans of highly policed information, starting with annual reports and accounts, interim and preliminary reports and highly regulated announcements on any price sensitive developments. They have the absolute right to attend annual general and extraordinary meetings to question the directors. The companies must maintain a web site and a register of shareholders and, until now, brokers' and others' published regular research.

Real popular capitalism

Economically it's a huge shame that investors are denied access to smaller companies. That's because we have an ageing population that needs to save to survive and the smaller company sector has not only performed well but the companies are entities with which people can identify.

Potentially, that's not just good for the investors it's also good for capitalism itself. It's what Thatcher tried to create with her privatisations - 'popular capitalism'.

For the record, in 2017 the AIM 100 index rose 33% per cent and the AIM All Share 24%, whilst the FTSE 100 managed just 8%. It's much the same picture over three years with the AIM 100 index gaining 76.9%, the AIM All Share rising 49.4%, but the FTSE 100 growth showing just 17% appreciation.

In many ways, the brokers have only themselves to blame for MiFID II. The provision of broker research had been ruthlessly abused for decades by corporate finance departments to support their client company share issues and, appallingly, by some analysts to stuff small shareholders by currying favour with major investment clients.

The most outrageous case was at the turn of the century when the star Merrill Lynch analyst Henry Blodget was banned for life from the securities industry after his e-mails were subpoenaed and released in 2002 by then New York Attorney General Eliot Spitzer.

Many believe that quoted companies should now regard research as a necessary listing cost. They should be obliged to commission and pay for research by authorised providers on the grounds that they have a responsibility to keep their shareholders informed. The providers should be voted on at the AGM, just like auditors.

We believe that companies simply need to understand that from now on there will be **'transaction brokers'** who deal with cash raising **and 'advocates'** who help companies understand the markets for their shares and debt.

'Magic or Mushrooms?'

No prizes for headline writing, but new statistics drove us to write a paper last year under this title and pose the question: **are private shareholders a magic ingredient in an AIM company's share register or are they to be despised and kept in the dark?**

Our view is clear, they are now THE MOST important shareholders for AIM companies and they need to be communicated with much more like FMPG (Fast Moving Packaged Goods) consumers than like institutional investors.

Openly available and honest information, clearly written should be delivered frequently to their screens at the most convenient time for them. Keep up a stream of information: announcements, research (the more the better), web conferences (Webinars) and occasional presentations to groups. It's all a lot less absorbing of senior management time than slogging around uninterested institutions and a LOT more rewarding.

Companies should still aspire to attract institutional investors, but just bear in mind that they are people too and nothing attracts attention like success, aka a steadily rising and justified share price.

Our conclusion was moulded by startling figures from the Office for National Statistics. For the first time the ONS has split data for AIM companies out from the whole market. It shows that retail investors form the largest cohort of investors in AIM, constituting just over 30%.

These are also the people who set day-to-day share prices. We have no precise figures for who buys and sells shares (liquidity) but as experienced market hands we reckon that for most SQC shares, 95% of trades come from individuals.

Here's the breakdown:

Top 6 holders of AIM shares	
Individuals	**30.6%**
Unit trusts	**10.6%**
Other financial institutions	**4.6%**
Pension funds	**2.7%**
Insurance companies	**2.3%**
Rest of the World	**45%**

Source: ONS, data to year end 2014

The Rest of the World would be time-expensive to pin down (but probably worth the effort).

However, the despised 'Individuals' own three times the number of shares than the once mighty Unit Trust sector and charities, churches, etc; Insurance companies; pension funds; Investment trusts; banks; other financial institutions; private non-financial companies and the Public sector own just 13.9% between them.

Food for thought we'd say and time for AIM company directors to question the obsessive drive and wasted effort involved in chasing after uninterested institutions.

Sure, keep in touch with some institutions that ARE interested like Gervais Williams, of Miton (and do read his excellent book 'The Future Is Small: Why AIM Will Be the World's Best Market Beyond the Credit Boom'). Keep in touch with other expert AIM investors like Ralph Baber and Mark Slater of Slater Investments, Judith Mackenzie at Downing, or Paul Jourdan at Amati; and don't forget the brilliant analyst commentators that influence professional and private investors alike: **Paul Scott** at Stockopedia and **Simon Thompson** of the Investors Chronicle spring to mind.

In summary, our view is simple: **if you want to shoot ducks go to a pond**. And the pond where the investors will welcome you and where they are hungry for good quality information is the private investor pool. Their support as reflected in your share price will get the institutions coming to you and thanks to the explosion of IT and social media, keeping in touch with them can be delegated and is less consuming of valuable management time.

We have long argued that private investors should be treated with more respect by both the market and the regulatory authorities but we mustn't ignore the impact of regulation in our planning, so some understanding of the background might be helpful. In 'Suits and Suitability' back in 2004 (see link) we said:

'The regulatory burden now represents a major cost of business. For example, in our field of company analysis, the total cost of analysis has remained roughly the same over the past three years even though the analyst wage bill has more than halved. Cost of compliance has made up the balance.

One effect of this is to deny investment to good companies, with a consequent impact upon their prosperity and that of the nation. Another is to deny access to information about excellent investments to millions of individual investors – the very audience that Government is most keen to protect.'

Even longer ago, in 1999, in 'Tomorrow's Giants' we warned that:

'The UK needs to foster entrepreneurship, at all levels of the business sector, and particularly in the layer of companies who have established themselves and have the potential for significant, in some cases huge, growth. This potential goes unrealised too often.'

Since then, of course, we have experienced the banking scandal and the consequent discrediting of the FSA, only to see it replaced by the FCA, which has leaped with glee upon the opportunity to armour plate its back with even heavier gauge regulation.

As one of the City's most respected thinkers, Lord Flight, said last year, ***'The banks caused the crash. The investment community was blameless, yet it has suffered even more stringent regulation.'***

Solutions

OK. So what to do about it.

First rule is, respect regulation but also respect the private shareholder's choices. He or she might be motivated by 'serious' investment criteria, but, the motivation might equally be the desire just to take a punt. It might be enthusiasm for your company, it could be excitement about your sector but it might be just a hobby. Whatever the motivation, private investors can be viewed as your customers with senior management sitting as the brand managers for the product that is the company, so treat them as you would any other audience. Target, analyse and nurture. It's basic Client Relationship Management.

All barriers can be overcome by responsible marketing and communication. We believe that individual investors and companies both need 'spread'. The best strategy for small investors is a wide spread of investments in smaller companies; the best for small companies in an age of easy communication is a wide spread of investors.

There are serious dangers in allowing a small company's share register to become dominated by a large single institution. One of the companies we have watched closely has a major institution, which regularly shorts the stock to drive the price down when it wants to increase its stake. A spread of small investors provides a barrier of liquidity against market manipulation of this kind and **a decent share price always leaves room to offer a discount to attract institutional support when new capital is needed.**

We have come to respect immensely some of the bulletin board investors. Often they know more than the professionals and, indeed, a lot of them ARE professionals who rely on their investing skills to support their families and lifestyles and they are inclined to do their homework even more carefully because they are investing their OWN money.

Many of them, however, have other jobs and what does that tell you? Well, think about it a little and you'll probably conclude that they might well review their portfolios at the weekend and what's to be concluded from that? Again it's common sense so where possible release information early on a Monday morning whilst your company is fresh in their minds and just like a Fast Moving Packaged Goods company, make sure that you refresh the story at every opportunity.

Lastly, do make sure that you have a voice with Government by joining the City lobbying organisation for Smaller Quoted Companies, the **Quoted Companies Alliance**. We were founders, they are very nice people and they do a good job.

Phone 020 7600 3745, ask for Tim Ward, he used to run AIM before the QCA so knows what he's up to, and say we recommended him.

If we can help you, do let us know. Call either Andy Edmond or Hannah Crowe on 0207 065 2690 or e mail info@equitydevelopment.co.uk

Equity Development has been working with small companies for 22 years, producing detailed research across a wide range of sectors during this period. We organise regular Private Investor Forums, Company webinars, and offer twitter commentary on company news.

If you would like to know how Equity Development's services might help your business or those of your clients, please email andy@equitydevelopment.co.uk or contact:

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