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Changes to Corporate Access – Tighten your Seat Belts, Everything may Change

Joerg Hoffmann, CFA
Senior Vice President Investor Relations, Wacker Chemie AG

Final FCA Rule on Dealing Commissions Now in Effect

- Final Ruling published in May 2014, PS 14/7
- Covers all buy side firms active in the UK
- Core is an unbundling of services either to be paid with commissions or from the asset managers‘ P&L
- FCA found only 2 out of 30 reviewed firms in compliance

Why should we care?

- UK and Ireland investors account for 23% of shares in MDAX-listed Companies*
- ESMA input into MiFID II with even tighter restrictions on research
- This is the time to review targeting and access practices

FCA = Financial Conduct Authority
*Wem gehört der börsennotierte Mittelstand?“, Cometis/Ipreo Ltd,. siehe http://www.cometis.de unter Studien

Regulation Frenzy –
Recent Changes to Research and Corporate Access

- **FCA published final ruling in May 2014, PS14/7**
  - only substantive Research to be charged to clients via commissions, corporate access not viewed as research
  - in effect since June 2014
- **ESMA Consultation paper on MIFID II Level 2, ESMA/2014/549**,
  - complete unbundling of services provided and paid for
  - research viewed as illegal „inducement“
  - in EU legislative process, expected from 2017
- **US Safe Harbor unchanged SEC Section 28e**,

  but conflicts of interest in bundling under scrutiny

ESMA = European Markets and Securities Authority; http://www.esma.europa.eu/

Issues that Drive the Recent Regulation Changes

- **Opacity** in pricing of individual services due to bundling practices by brokers stifles competition in the market for research
- **Lack of Transparency** of costs and better disclosure to customers
- **Conflicts of interest**, bundled services instead of best execution
- Lack of scrutiny on costs by asset managers to the detriment of investors
- **Link between trading volume and research** supports unsound investment practices (access to „free" research influences direction of order flow, supports churn of client portfolios)
- **Potential cross subsidizing of funds** when some funds pay for research benefitting others, allocation of costs

What has changed so far? – Not much

- Corporate Access is not research per FCA. Paying for research gets more complicated going forward.
- Brokers offer corporate access free of charge. Conference participants pay for conference attendance. But the FCA wants to see disclosure on costs…
- The link between corporate access and trading volume will still be a major factor in who gets broker attention, but this is likely to stop after MIFID II
- Mandated unbundling of services (trade execution, market information, research, corporate access etc.) will significantly change IR environment

Taking it a Step Further: The Theory behind Unbundling

- Explicit pricing of external research would improve the economic efficiency of the market and would allow consumers more easily to make ex ante judgments as to which investment approaches they wished to support. Explicit external research pricing would allow better comparison with the cost and value of internal research teams and may diminish the over-supply and over-consumption of research.*

- Members of the UK CFA society in a survey last year reflected this view: only 37% of respondents believed that buy side firms should use a client's money to pay for research, and nearly 60% believed that the current market framework does not best serve the interest of investors.**

- A recent study conducted on US mutual funds also suggests that, not only do investors overlook costs that are bundled with dealing commission, but also that the opaque costs are those that are most detrimental to performance. As such, transparent and easily comparable costs would improve the overall functioning of the market.***

* CFA Society UK, *The Market for Research*, p.12; ** CFA Society of the United Kingdom, 'Survey on the future of investment research' (2013); Edelen, R. Evans, R.B. and Kadlec, G.B., 'Disclosure and agency conflict: Evidence from mutual fund commission bundling', Journal of Financial Economics, Volume 103, Issue 2, February 2012, Pages 308–326; all quotes from DP14/3

The FCA Approach to Unbundling: Defining “Research”

- **Research can be billed to the customer brokerage (paid for by dealing commission) and is not an operating expense of the asset manager (paid for by fees)**
- **FCA* now defines “Substantive Research” (COBS 11.6.5E) as:**
  - Capable of adding value to the investment or trading decisions by providing new insights to investment manager for customer portfolios
  - Represents original thought, in the critical and careful consideration of new and existing facts, must not merely repeat what has been presented before
  - Has intellectual rigor and must not merely state what is commonplace or self-evident
  - Involves analysis or manipulation of data to reach meaningful conclusions for the investment manager
- **Research can be paid for with commission charged to the customer, only if these *cumulative* criteria are met**

*FCA = Financial Conduct Authority, UK regulator. CP 13/17 and PS 14/7 and COBS published May 1st 2014, effective June 2nd 2014, also see at http://www.fca.org.uk/news/cp13-17-use-of-dealing-commission

The ESMA Approach to Unbundling: Research as Inducement*

- Asset manager can receive only “minor monetary benefits“ in exchange for dealing commissions
- (…) ESMA considers that any research that involves a third party allocating valuable resources to a specific portfolio manager would **not** constitute a minor non-monetary benefit and could be judged to impair compliance with the portfolio manager’s duty to act in their client’s best interest.
- (…) provision [*of research*] is likely to influence the recipient’s behavior and cannot be a minor non-monetary benefit. This would include privileged access to research analysts (e.g. face-to-face meetings or conference calls), bespoke reports or analytical models, investor field trips, or services linked to research such as corporate access and market data services, which by their nature are limited in access and/or can have a material value.

*ESMA Consultation Paper on Mifid II, May 22nd 2014, ESMA/2014/549, Section 2.15, page 121 Paragraph 14;
http://www.esma.europa.eu/content/Consultation-Paper-MiFID-IIMiFIR

What‘s Next?

- 2017 is still far out. After all, MIFID II may finally look different from what ESMA suggests today
- The need to avoid regulatory arbitrage facilitates bridging the US and FCA/ESMA approaches
- Either way, transparency for customers is here to stay, more disclosure requirements for asset managers
- IOSCO looks at unbundling
- Regulators seem to be bound to support a market for research

IOSCO = International Organization of Securities Commissions

Pricing Research – Potential Side Effects

- **Brokers will have to quote prices for research, either under the current FCA policy or mandated under MIFID II**
- **This enables the buy side to do a proper „make or buy“-analysis**
- **An unbundled offering of research with a „real price“ attached could**
  - create a market for research
  - may reduce non value added research (e.g. quarterly over/under maintenance reports)
  - direct analyst attention to under-researched, smaller corporates (it‘s hard to sell the 50th report with similar findings on a large cap)
  - reinvigorate quality of research
- **Brokers may review the need for independent research, why not sell biased research as a loss leader as long as it is clearly marked as such?**

The New Corporate Access Approach

IRO's to take the initiative

- Conferences are simple, pricing is clear: no big change to old business model
- Leverage broker market intimacy
- Be open to reverse roadshows
- Run your own Non-Deal Roadshow
- Use a combination of targeting and marketing, push/pull tactics
- Be open to new business models

*PS 14/7

Changing the way Corporate Access gets priced: The IR Opportunity

Disintermediation:

- Necessitates closer contact to the sell side (Analysts AND Sales) for IRs to better gauge demand
- Improves IR understanding of meeting demand or lack thereof
- Allows meeting schedules independent of broker client lists
- More control over the schedule for IR

Market mechanism:

- Clear expectations on meetings
- Price becomes a good indicator of demand/quality of meetings
- Democratized access for investors

What now? To Do List for IR

- **Engage and stay in touch with your brokers**
- **Take targeting more serious**:
  - It‘s not just the WHO, it is also the WHY
  - Watch out: the WHY response can actually change during the cycle
  - Use a CRM solution to track notes on investors and the requested frequency of meetings
- Check corporate access quality and give quality feedback to banks
- **Try new ways** to access investors:
  - Get to know their booking desks
  - Publish your roadshow schedules
  - Try an intermediary
- Enjoy independence by paying your own way – reduce opportunity cost
- **Leverage analyst** intimacy with your client, make sure they get the votes

WACKER: Issuer, Contact and Additional Information

Issuer and Contact

- WACKER CHEMIE AG
  Hanns-Seidel-Platz 4
  D-81737 Munich
- Investor Relations contacts
  Mr. Joerg Hoffmann, CFA
  Tel. +49 89 6279 1633
  joerg.hoffmann@wacker.com
- Mrs. Judith Distelrath
  Tel. +49 89 6279 1560
  judith.distelrath@wacker.com

Additional Information

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Financial Calendar

10/30/14 – Q3 Results 2014

11/25/14 – 11/26/14

Deutsches Eigenkapitalforum in Frankfurt