

European Commission
Directorate-General for Financial Stability, Financial Services and Capital Markets Union
European Commission
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Targeted consultation on the listing act: making public capital markets more attractive for EU companies and facilitating access to capital for SMEs

The European Association of Independent Research Providers (Euro IRP) was founded in 2004, and is recognized by regulators, asset managers and the wider investment community as the ‘voice’ of independent investment research firms. Euro IRP represents the interests of such firms who are based in Europe, or who provide services to the investment community in Europe. With over sixty members firms, the combined resources of Euro IRP member firms comprise more than 600 experienced investment analysts or strategists, with annual revenues exceeding €230 million. Euro IRP has an active, ongoing role in deepening relationships with financial regulators, including a special annual discussion meeting where the IRP community can hear from and engage with regulators across the UK and EU.

This document provides an extended version of the Euro IRP online submission to the EC consultation on the Listing Act: making public capital markets more attractive for EU companies, and facilitating access to capital for SMEs. Euro IRP is well aware that in the formulation and inception of MiFID II regulations, that authorities were very aware of the potential for unintended consequences that might damage the SME marketplace, and thus committed to taking necessary steps to ameliorate such consequences, should they seem to arise. Clearly, markets have changed and developed since MiFID II came into force across Europe on 3 January 2018, but this consultation is a clear signal of that ongoing commitment, and hence is recognition of the challenges SMEs face in attracting and retaining capital markets interest.

Central to the health and vibrancy of the SME marketplace is the provision of research and analysis on these stocks – to enhance the information flow; to stimulate interest and debate; and to provide integrity and transparency to support and protect the interests of ultimate investors. Euro IRP has revised commentary and responses to the relevant sections of the EC consultation (provided online, and with extended commentary in this document).

The fundamental points we would want to highlight are -

- The pressing need for independent research firms to be exempt from the inducement rules in MiFID II, and for independent research to be classified as minor, non-monetary. Adoption of this approach by the EC and European regulators would mirror the approach being taken by the FCA in the UK (as of 1 March, 2022); and be a quick and simple ‘win’ for the entire investment industry.

- The need to consider the removal of the cross-subsidization of research provided by investment banks and brokerage houses. All such research is inherently conflicted, and aims primarily to enable the investment bank or brokerage firm to sell other services to the asset management community. The rules on inducement in MiFID II sought to unbundle this relationship. However, as long as banks and brokers can subsidize the costs of their research, the full, intended benefits of unbundling can never be realized. Cross-subsidization perpetuates the production of conflicted research, that undermines market integrity and does not serve the interests of ultimate investors.
- The importance of stimulating and supporting high-quality, independent issuer/venue paid research. The asset management community alone lacks both the resources, but more importantly, the commercial incentives to properly fund such research, even though this research is a core requisite for a healthy, growing SME market. Encouraging greater production and distribution of research on SMEs which is funded by issuers (either directly or through venues & exchanges) needs to be accompanied by policies which ensure this research is seen as independent and valuable by investors. We set out below several ways in which this can be achieved.

Euro IRP would welcome the opportunity to meet with appropriate EC representatives, be it through ESMA or otherwise, to discuss and progress the issues here.

75. Do you consider that the alleviation to the research regime introduced with the capital markets recovery package has effectively helped (or will help) to support SMEs' access to the capital markets?

- ☐ Yes
- ☒ **NO**
- ☐ Don't know/ no opinion / not relevant

Please explain your reasoning:

There are two main reasons why this change is unlikely to be effective. Firstly, it comes after the fact. Asset managers have already spent considerable time and effort to establish procedures to value and pay for research services under MiFID II rules, and hence are extremely unlikely to alter those procedures to now charge SME research via commission. This would be complex and costly for asset managers to try to separate out such research; and very challenging to revert to asset owners to secure their approval to carry the costs of this research. Secondly, the long term secular trend towards diminished coverage of SME stocks simply reflects the commercial realities that SME stocks cost as much as large cap stocks to research and cover properly; yet the contribution to AUM and fund performance that SME holdings can make is small and often inconsequential by very definition – meaning it is simply uneconomic for asset managers and for research providers. There needs to be a different business model, based on issuer or exchange/venue funding. This presents the opportunity for the provision of quality and diversity of research, which can be made freely and widely available to the buy-side, and hence stimulate interest and investment in SMEs. Such research needs to provide market integrity and transparency by clearly disclosing the payment mechanism, and by requiring independence of the research provider from any outside influences.

76. (a) Would you see merit in alleviating the MiFID II regime on research even further?

- ☐ YES
- ☐ No
- ☐ Don't know/ no opinion / not relevant

Please explain your reasoning:

The intention of MiFID II rules to formally unbundle research services payments from execution and corporate finance services was to restore market integrity by making research services payments based purely on the value and quality of those services alone. Such transparency was also intended to increase competition, outlaw inducements and remove unnecessary costs for asset owners by eliminating sub-standard, 'me too' research. It is very clear that these anticipated benefits have not materialized. There has been very few (if any) new entrants into the market for research services provision; amounts paid for research have declined, by around 30-40%, and the number of research services counterparties used by asset managers has dropped by a similar amount. The only truly effective way of addressing this would be to prevent cross-subsidization of research services that continues apace by the investment banking and brokerage communities. This, however, would be a complex, long-winded and challenging manoeuvre. A straightforward and immediate step would be for independent research providers to be placed outside of MiFID II inducement rules. This is the policy being implemented by the FCA (from 1 March, 2022), and EU regulators should follow suit. Partly this would therefore give commonality across UK & Europe, but much more importantly it would stimulate discovery (the lack of which is a hindrance to asset management performance, investment and the efficient functioning of markets), and encourage the provision of quality, non-conflicted research – that only a genuine independent research provider can deliver. The key point here is that this would mean much greater integrity of any research output, leading to better investment decisions, improved returns for end investors, and in parallel an ongoing reduction in conflicted research, which both hampers the investment decision process, and undermines market integrity.

(b) If you answered "Yes" to question 76(a), please indicate whether you consider that written material other than the one currently falling under the minor non-monetary benefits regime could be added to that list.

- ☐ YES
- ☐ No
- ☐ Don't know/ no opinion / not relevant

Please explain your reasoning:

As stated above, the extension of the minor non-monetary benefits regime to include written materials (and indeed all research services) provided by recognized, genuine independent research providers (IRPs), should be adopted. This approach is exactly as that being introduced by the FCA, with the key definition of an IRP being that this entity stands alone, without trading, execution services or corporate finance services being provided. As stated, this extension is simple and clear to bring into effect; would offer an immediate uplift in market integrity and transparency; give asset managers more opportunities for discovery and enhanced investment decision processes; and benefit ultimate investors too - all within the existing MiFID II framework.

(c) If you answered “Yes” to question 76(a), please indicate whether you consider that FICC (fixed income, currencies and commodities) research and research provided by independent research providers should be exempted from the unbundling regime introduced by MiFID II.

☐ YES

☐ No

☐ Don't know/ no opinion / not relevant

Please explain your reasoning:

Whilst the aim to include FICC research within MiFID II scope was understandable, as it offered commonality of approach across all instruments and asset classes, the very different nature of FICC research historically – with research costs being embedded in the spread, and being a market where ratings agencies were deeply involved – meant that from the outset, the application of unbundling rules has never really worked. There are many twists and turns here, but the cold reality is that although FICC research is meant to be valued and paid for separately, and hence not in the spread, spreads themselves have not reduced. Asset managers, and by implication, asset owners, are now either paying twice for FICC research, or not applying MiFID II rules and still paying for FICC research in a bundled fashion. Removing FICC research from MiFID II scope is a reflection of the reality of the way this market operates.

For independent research providers, all the points mentioned in response to the earlier questions in this section above apply – it is clear that IRP research should be made exempt, in order to stimulate competition, encourage diversity of opinion, deliver market integrity and transparency, and eliminate hidden costs from asset owners. Whilst it would be wrong to overstate the impact of exempting IRP research from MiFID II unbundling – of itself, this move would not mean the research services market would become perfect, or indeed nearly perfect – the rationale for doing so goes to the fundamental purpose of financial regulation. Markets need to operate on a basis of integrity, transparency, and fairness. Investors need to be protected from market abuse. Giving independent research providers – the only organizations offering unconflicted research services – more opportunity to compete, and to gain greater visibility and traction for their views, is an essential component in delivering on those fundamentals.

(d) If you answered “Yes” to question 76(a), please indicate whether you have any further concrete proposal.

Please explain your reasoning:

There are, as discussed in the responses to the preceding questions, a number of concrete steps that can be taken.

One – make research services delivered by independent research providers exempt from MiFID II inducement rules. The simplest and quickest way to do this is to include all such research services from IRPs as minor non-monetary benefits. This echoes the FCA approach, and means the change can be implemented essentially immediately, without the need to rework or reconfigure MiFID II rulebook any level of complexity. This step will enhance market integrity, transparency, competitiveness and the efficient operation of the European capital markets. As noted, not only is this a concrete practical step that can be taken, it is one which is very straightforward to introduce. The template for this already exists (in the form of the move by the FCA), and it could be implemented with minimal delay or difficulty. It would also therefore represent an immediate ‘win’ for this review process.

Two – support and facilitate high quality, independent, issuer paid research. As noted elsewhere, the core challenge for SME markets, and thus for SME research, is the commercial reality that the costs to produce it in the quality and volume needed to provide widespread coverage and stimulate investments, exceed significantly the revenues capable of being generated. The wider regulator interest lies in a very healthy SME capital market, but the asset managers (and asset owners) do not gain proportionally from carrying all the cost of funding the SME research needed. In essence, they are being asked to fund the greater good, and they are not doing so, because it is not in their commercial interest to do so. By altering the commercial basis, and instead moving the costs to the issuer (directly or indirectly), the market can actually start to make sense. This then needs to be focused on the delivery of a transparent, high quality research product, with genuine integrity, which is freely and openly available to asset managers. The combination of a widely distributed product, where the funding mechanism is clearly identified, that is created to high standards of integrity and robust analysis, will both support a stronger investment decision process for SME stocks, and stimulate overall interest and investment in the SME market.

Three – as an extension of the above, packaged pricing for SME research provision could help market transparency and increased coverage of SME stocks. This would take the form of research providers bidding to offer coverage for a package of stocks in a sector, and for an issuer to draw upon those providers rather than having a more direct relationship. This offers the opportunity to manage conflicts for issuer or exchange/venue sponsored research, by essentially spreading the responsibility on both sides.

Four – establish SME research templates. A standard SME template could be agreed that focuses more on information, risks and valuation ranges etc., rather than recommendations and target prices. It is well established that asset managers place far greater weight on underlying analysis and ideas from external research providers, than they do on price targets or recommendations.

Five – regulators in the EC, at a national and EU level, are understandably increasingly focused on ESG issues, and how investment needs to be run against ESG criteria. In achieving real change here, governance within asset management firms needs to take full account of such criteria in how they consider investment opportunities. We would propose that asset managers should be required to use at least one genuine independent research provider, among their research service counterparties. Only independent research providers, who, by definition are delivering unconflicted research are the only players that can guarantee market integrity over the long term. Euro IRP promotes a clear distinction between commission-based financial research that fully falls under the MIFID II guidelines and subscription- based IRPs with no interest whatsoever in transactions. This then produces very obvious and practical definition of independence, helping the whole investment industry, buy-side and sell-side alike, and is a timely move when investment processes themselves are expected to be ESG compliant, and need to utilise research services to protect and ensure the best interests of savers. IRPs are naturally aligned with that most essential obligation.

Six – remove the cross-subsidization of investment bank and brokerage research. Some context here may be useful. The research market, in a sense that we can recognize it today, developed essentially in the 1950s and 1960s as a way for brokers to stimulate interest in stocks, and then generate revenues by the resultant execution services they provided. All the market changes since then, and the dominance of the investment banking model, have only served to reinforce that – research services are delivered to act as a gateway to execution, trading, corporate finance and other services. Research services provided in this way are conflicted. MiFID II was seeking to unwind some of those inherent, and deeply embedded conflicts, but has in many respects been unable to do so. The only effective way to address this, is to require research services that investment banks and brokerage firms operate, to be run as standalone, self-financing activities. A simple way to drive change in this regard would be for regulators, using existing powers, to require greater disclosure by the investment banks about how much of their research costs are covered in-house vs by third parties; what their average fees across their research business; and the other key components of their financial position and commercial proposition in relation to their research services provision.

78. How could the following types of research be supported through legislative and non-legislative measures? Please put an X in the box corresponding to your chosen option for each type of research listed on the table.

	Legislative measures	Non-legislative measures	Don't know/No opinion/Not relevant
Independent research	X		
Venue-sponsored research			
Issuer-sponsored research			

79. In order to make the issuer-sponsored research more reliable and hence more attractive for investors, would you see merit in introducing rules on conflict of interest between the issuer and the research analyst?

☐ Yes

☐ **NO**

☐ Don't know/ no opinion / not relevant

Please explain your reasoning:

By definition, there is a conflict of interest when the issuer is paying for the research on itself. This is unavoidable, and any attempts to regulate this would either just not work, or would likely have the effect of significantly reducing such research. What is required is, in many ways, the opposite. Research paid for by issuers (either directly themselves or indirectly through exchange/venue funding or some such similar mechanism) needs to be very clearly flagged to inform the asset manager (or any consumer) of the payment structure behind it. That would deliver transparency, and enable the asset managers and investors to have an immediate yardstick on which to assess the value of the research.

80. What should be done, in your opinion, to support more funding for SMEs research?

Some of the earlier comments refer to this question. SME research coverage has been in secular decline for two decades. The single biggest driver of this decline has been that it is an uneconomic business model, as the markets are currently structured. In order to initiate and maintain quality research coverage of an SME requires an annual spend of circa €40,000, and often more. It costs as much as it does to provide coverage of a large cap stock, and can in many cases be a higher cost, as information is less readily available, and analyzing an innovative business model can be more challenging. However, the addressable market for SME research is markedly less than for large cap stocks. Asset management firms running funds that include both large cap and SME stocks, or separate funds, will have their AUM obviously weighted towards the large cap stocks; and hence their fund performance likewise. Returns for end investors are similarly ineluctably dependent on large cap holdings. Asset managers who specialize in SME stocks are comparatively rare, and certainly massively outweighed by larger cap funds. Asset managers will, therefore, focus their research spend on the areas of most value, and overall return. These are simple facts, which mitigate against quality SME research being paid for by asset managers, and why there is less research coverage of SMEs, and in particular, less quality and variety of coverage.

The importance of the SME market is undeniable – indeed, both MiFID II itself, and in this review – are deeply concerned with strengthening and protecting this market. A vibrant, healthy SME market is an essential component of the capital markets, and a vital element in funding for the long term growth, innovation and health of European economies. It needs quality, variety, and competitiveness of research to help identify investing opportunities, and to stimulate and support asset management interest.

Issuer paid research (either directly or exchange/venue funded) would seem the only business model that can deliver this level of research. In order to be effective, SME research that is funded by issuers needs to be widely and openly available to the buy-side – in itself this will add to interest and activity in this part of the market. Making such research freely available is one part of the solution. The other part is to encourage transparency and integrity in the research itself. The research needs to be clearly flagged as to its funding, so that the recipients are completely aware of the ‘provenance’, as it were. Secondly, both the research provider and issuer should be strongly encouraged to deliver independent views and proper analysis, even if that results at times in unfavourable commentary. There are three further points here. Firstly, it is hard to see how the research could be legally forced to be independent, and as such, a rules-based approach is not going to work. Secondly, the more independent, insightful and robust the research is, the more it will be valued and used by asset managers, and hence ultimately the more valuable it will become for issuers themselves. Excellent, high quality, independent research will generate a virtuous circle of greater buy-side interest and investment, and ongoing issuer transparency and approachability. Thirdly, it will be research from independent research providers that is most likely to deliver the required quality. Whilst existing brokerage research can be good, it is dominated by the inherent conflicts of the business model. The single most compelling evidence for this is the massive preponderance of *buy* recommendations as opposed to *sell* recommendations, that investment bankers and brokers deliver.

The vital point here is the argument already made above that legislative adjustment to MiFID II rules relating to inducements should be enacted to exempt independent research providers (IRPs) from those requirements, and treat such IRP as minor non-monetary benefit. This approach is about to be formally adopted by the FCA, with relevant rulebook changes applying from 1 March, 2022. This legislative change removes an obvious anomaly that exists at present, which runs against the spirit and intent of MiFID II. MiFID II was rightly very concerned to remove inducements, and in the case of research services, to unbundle research payments from execution commissions, in order that the consumption and payment for such research services was not influenced by execution payments or services. Now, independent research providers, by very definition, do not offer other services which they wish clients to purchase, that they can use research as an inducement. The business of an IRP is research, unconflicted and with no associated inducement risk. As such, independent research providers have been unfairly penalized by being included in the scope of the MiFID II inducement rules, when these should only, and correctly, apply to investment banks and brokerage firms, who would wish to use their research services as an inducement to asset managers to then utilise their execution services.

The European Association of Independent Research Providers
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