Investment Research Review Call for Evidence

UK Finance and AFME response

Submitted on 24 April 2023

Dear Rachel,

Please find enclosed the collective responses of UK Finance and the Association for Financial Markets in Europe (AFME) members to the Investment Research Review Call for Evidence. This initiative represents another important step in the government's wide-ranging programme of reforms geared towards strengthening the UK's capital markets – an agenda which we firmly support.

Capital markets play a fundamental role at the centre of the UK's financial services ecosystem and are key to supporting the UK's longer-term economic future. In progressing a range of measures to improve the UK's capital markets, the government is rightly focussing on investment research as one factor amongst a range of others that should be given due consideration. A dynamic investment research ecosystem is key to well-functioning and competitive capital markets.

The main themes addressed in our response are as follows:

- **Research is only one of many factors which determine the UK's competitiveness:** Whilst improvements to the provision of investment research in isolation will not be a 'silver bullet' for addressing wider issues attributed to the UK's capital markets ecosystem, it is right for this area to be considered alongside other ongoing reforms.

- **Future regulatory changes should reflect the uniquely global nature of investment research:** The investment research market is inherently international and further changes to the UK's regulatory and legislative environment should prioritise where possible alignment with other jurisdictions. It should also provide a level playing field for both UK providers and consumers of research competing with international counterparts. We note that similar themes are being addressed in ongoing discussions by other policymakers, and it is important for respective UK initiatives to be cognisant of developments in other jurisdictions such as the US and EU.

- **Members have observed that MiFIDII has impacted the research market:** The MiFIDII unbundling rules have led asset managers to scale back on the number of research providers they use; competition and analyst coverage – particularly at the smaller end of the market – have suffered as a result. Whilst MiFIDII has been beneficial in bringing greater transparency to the investment research market, this has been at the cost of limiting flexibility and increasing operational complexities that disproportionately impact smaller market participants. The UK's capital markets could benefit if this balance were to be redressed.

- **Allowing broader optionality for research payments would improve the UK's position:** Pursuing further targeted changes to the existing regime (e.g., through adjusting the market capitalisation exemption or sector-specific exemptions) is unlikely to achieve the objectives identified by this review. Instead, UK Finance and AFME members are supportive of an approach whereby a broader level of flexibility is applied such that clients have the option to choose how they pay for the research they consume i.e., either bundled or unbundled, by removing the requirement on market participants to unbundle which is currently contained in MIFID II.

- **Non-MiFID regulatory drivers also play a role:** In our response we have given consideration to several other regulatory regimes which impact the provision of investment research in UK capital markets. There may be value in considering options to streamline relevant aspects of the UK's corporate access requirements, Market Abuse Regulation (MAR), and COBS, so far as the costs of any changes are proportionate to the benefits derived.

- **Investors value independence:** The material value which clients and investors place on the independence of the research they consume should not be underestimated as future changes to the UK's research ecosystem are considered. We do not consider the provision of more sponsored research as being the best solution for investors in order to increase stock coverage.

We are grateful for the opportunity to contribute to this important initiative. Given the short window during which this response has been complied, the views and positions presented below represent a summary of preliminary discussions with UK Finance members. We therefore look forward to the opportunity to engage with yourself and policymakers in the coming weeks and months to further explore the positions set out in this response.

If you have any immediate questions in relation to this submission, please do not hesitate to get in touch.

Kind regards,

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About UK Finance

UK Finance is the collective voice for the banking and finance industry. Representing more than 300 firms across the industry, it seeks to enhance competitiveness, support customers and facilitate innovation. Our primary role is to help our members ensure that the UK retains its position as a global leader in financial services. To do this, we facilitate industry-wide collaboration, provide data and evidence-backed representation with policy makers and regulators, and promote the actions necessary to protect the financial system. UK Finance's operational activity enhances members' own services in situations where collective industry action adds value. Our members include both large and small firms, national and regional, domestic and international, corporate and mutual, retail and wholesale, physical and virtual, banks and non-banks. Further information is available at www.ukfinance.org.uk.

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About AFME

The Association for Financial Markets in Europe (AFME) is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. We represent the leading global and European banks and other significant capital market players. We advocate for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. We aim to act as a bridge between market participants and policy makers across Europe, drawing on our strong and long-standing relationships, our technical knowledge and fact-based work.

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1. ***How does investment research provision in the UK compare, or how is it perceived to compare, with other major international financial services centres?***

Global observations

There is a general perception that the provision of investment research, both in the UK and throughout other jurisdictions, has been impacted in recent years. Whilst it is difficult to make direct international comparisons given the global nature of investment research, our members have observed the amount of resource buy-side firms have available to pay for research has diminished since the introduction of MiFIDII (the reasons for this are discussed in our response to Question 5), and both the level and seniority of global analyst coverage has been affected as a result.

Furthermore, the focus of firms' (now smaller) research budgets has tended to drift towards other jurisdictions largely as a result of changes in where issuer and investor activity is centered, rather than as a direct consequence of the way investment research is regulated in the UK (notwithstanding the impact of MiFIDII on the size of overall research wallets).

Quantity

Our members note that the quantity of research produced in any given market is largely dependent on the activity taking place in that market (e.g., the number of listed companies; initial public offering (IPO) prospects; secondary issuance). Investment research activity naturally tends to shift towards markets where the demand for research is strongest. Based on anecdotal feedback, some of our members believe the total number of firms providing research post-IPO today for newly-listed smaller cap companies is more limited than in recent years.

The US has a deeper pool of research, both in terms of volume of research in the market and coverage per stock. Neither have changed materially post MiFIDII and that is likely because of how research is funded in the US. Given the material difference in the breadth and depth of the US trading market, there is a greater level of trading interest by investors in a wider range of stocks, which in turn drives demand for research.

Quality

UK Finance and AFME members tend to produce globally branded and distributed research products which are consistent in quality regardless of the jurisdiction from which they originate.

Some members have however observed that clients have become more selective about the research providers they speak with, given the reduction in research budgets and the high costs for analyst interaction, which in turn has affected the number of senior analysts in the market. This has impacted high-touch interactions that take place, which are valuable for investors in their stock decision process.

In this context, our members have also highlighted that the most valuable element of investment research for clients is more often derived from the associated dialogue and interaction between analysts and clients, rather than the written analysis itself.

2. ***What is your assessment of the amount, quality and type of investment research currently provided on companies that are listed or quoted, or seeking to be listed or quoted, on the UK public markets?***
    - ***Has that position changed since 2014 (when the UK took steps regarding the use of dealing commission) (or earlier) or 2018 (when the MiFID II unbundling rules came into effect)?***

- ***If you are aware of particular differences relating to specific sectors (e.g. technology and/or life sciences), please provide further details.***
- ***If you are aware of particular differences with other jurisdictions, please provide further details.***

Please see our response to Question 1 above.

As noted in response to the previous question, the introduction of the MiFIDII unbundling rules in 2018 has led to an overall reduction in research budgets and has impacted the research market globally. Our members note that the impacts of the 2018 changes were more notable than any consequences resulting from the changes introduced in 2014. Since 2018, members have also noticed a degree of consolidation in the industry and that a number of analysts have moved to the buy-side and private equity firms.

We would further reiterate that jurisdictional comparisons are not necessarily the most effective way to assess the provision of investment research, given the global nature in which research is produced and consumed.

3. ***How important is investment research to the attractiveness of the UK public markets to listed companies (or companies considering listing) and their investors or to companies looking to access capital in private markets? - Is there a specific link between research and valuations for listed companies or those seeking to list?***

Importance of research

The presence of accessible, high-quality investment research is a central feature of well-functioning primary and secondary capital markets; providing information that enables market participants to make informed investment decisions and aids price discovery.

Pre-deal research which is produced in connection with IPOs and associated investor education are an important part of primary markets. Furthermore, ongoing research coverage of listed companies is key to supporting the liquidity of their shares on the secondary market. Generally, the availability of more research on any given company or investment product can facilitate a greater interest amongst investors.

In addition to this, our members note the important role which investment research and suitable analyst coverage can play during times of market stress and volatility, particularly when issues may be concentrated with a certain sector or group of companies.

Company valuations

Whilst the availability of research on a particular company does play *a* role in the assessment of its value, our members note that it is only one factor amongst a range of determinants which are taken into consideration by issuers when choosing where to list their shares, and by investors when assessing a company's value and investment viability.

Our members do not believe there is an exclusive and 'specific' causal link between the level of research produced on a particular company, and the valuation which that company achieves on the primary market. Nor is perceived research coverage on a particular company a sole driver in that company's choice of listing location.

4. ***Are there specific issues relevant to UK investment research on technology and life sciences companies that should be addressed, including compared to other jurisdictions?***

Our members have not observed any specific issues with regards to investment research coverage on technology and life sciences companies.

Generally, we would caution against taking a divisional, sector-by-sector approach to applying existing regulations and when assessing the UK's broader research landscape. This is discussed in more detail in our response to Question 8.

5. ***Are there specific issues relevant to UK investment research on smaller UK listed or quoted companies that should be addressed?***
    - ***What counts as "smaller" for these purposes?***

As we have referred to in response to previous questions, the introduction of the MiFIDII unbundling rules has led to an overall reduction in the research budgets of buy-side firms, having required asset managers to fundamentally change the way they paid for research (either out of their own P&L or through a Research Payment Account (RPA)). This requirement placed a greater emphasis on the 'added value' derived from any research purchased and asset managers have consequently adopted a more selective approach to procuring investment research.

Smaller fund managers in particular had to consolidate their research consumption in response to the increased operational costs and complexities associated with MiFIDII compliance, and there has been a general reduction in competition observed in the market for investment research. These impacts have been more acutely felt by smaller, independent research houses – which also tend be those who cover "smaller" companies that are followed by a more niche client base.

UK Finance and AFME members are of the view that this reduction in coverage cannot be solved by mandating the re-bundling of research and execution costs for distinct segments of the market. As set out in response to Question 8, we do not believe that seeking to boost research coverage on smaller companies through the use of exemptions is the most effective approach. Further changes or divisions would only create additional cost and complexity now that buy and sell-side firms have built MiFIDII-compliant systems. Our members believe that providing investment firms optionality on how they pay for research would be the most appropriate route (see response to Question 12).

6. ***What demand do investors have for research on UK listed and quoted companies, what are the factors driving this demand, and is the amount, quality and type of investment research currently provided sufficient to meet this demand?***

Our members note that demand for investment research is generally derived from issuer and investor activity. If there is a large concentration of capital raising activity and centred in one jurisdiction or, more importantly, if a given jurisdiction is home to a large number of listed companies (such as the US), there will generally be a greater demand from investors for information and research on those companies in that particular market.

7. ***What impact does the current UK legislative and regulatory environment have on the provision and quality of research, including (but not limited to) the MiFID II***

unbundling rules? Please provide references to relevant legislative/regulatory provisions with your answer where relevant.

MiFIDII unbundling rules

As referenced throughout this response, UK Finance and AFME members have observed that the MiFIDII unbundling rules introduced in 2018 have had the overall effect of reducing the size of firms' research budgets, which has impacted the provision of investment research globally. Some members have observed a reduction in the seniority and experience of some sell-side research analysts and salespersons.

Investment research is a global product and as such the separate revisions made to both the UK and EU MiFIDII regimes post-2018, in an effort to improve research coverage, have instead had the effect of introducing additional layers of complexity for market participants to navigate and exacerbated existing challenges for smaller clients, start-up funds, and research providers in particular.

Furthermore, for research on non-equity products in particular, our members have observed that clients continue to face difficulties in the practical interpretation of the MiFIDII unbundling rules and subsequent UK revisions introduced in 2022.

COBS

Our members note that the introduction, in 12.2.21A in COBS 12, of a prohibition on analysts interacting with a prospective investment banking client prior to mandate created additional complexities as the flat prohibition was more restrictive than the rules imposed in similar markets such as the US and EU. In the interests of promoting global alignment, there could be benefit for the UK's research market in adopting an approach which is more consistent with that of its peers.

Our members also note that the FCA's 2018 COBS 11A rules, regarding the timing of unconnected research, introduced an additional week of potential market risk into the IPO launch timeline, which risks creating heightened timing sensitivity for UK IPOs relative to EU and US IPO timetables. Members support the FCA's efforts to improve the range of information that is made available to investors through inclusion of unconnected research in the IPO process, but members have not seen any marked increase in the publication of unconnected research since 2018 and in particular not at the time of publication of the Intention to Float (ITF) announcement and publication of syndicate analyst research. Arguably, the benefit of provision of information to unconnected analysts could be preserved by publication of the registration document concurrently with the ITF, and not a week earlier as currently required – this would reduce market risk for IPO issuers and provide more timetable flexibility overall, which would be particularly beneficial in more volatile IPO markets.

UK Market Abuse Regulation (MAR)

UK Finance and AFME members have also highlighted the impact of MAR on the UK's investment research landscape. The requirement for providers of investment research to publish additional disclosures under MAR, for example in relation to sales commentary and trading, can be cumbersome and introduce additional complexity compared to respective approaches taken by other jurisdictions. Difficulties in interpreting the scope of instruments caught by MAR can also lead to UK-specific complexities in undertaking investment research. Our members also note that, in some cases, the burden of producing such disclosures is not necessarily proportionate to the benefits they bring to the market.

Corporate access

Corporate access is an important channel for issuers to engage with potential investors and an opportunity for learning for analysts listening in to those conversations. Our members note that the UK takes a stricter approach (or is at least perceived to) to corporate access when compared to some other jurisdictions. This approach can contribute to a more complex regulatory environment and inhibits access to issuers. We set out further detail in our response to Question 10.

Listings and pension rules

The UK's wider ecosystem for listing and pension fund allocation plays a role in shaping the UK's investment research landscape. In particular, the observed preference for UK pension funds and institutional investors to focus investments in lower-risk asset classes such as gilts, as opposed to domestic equities, is one factor contributing to a reduced demand from investors for investment research on UK companies.

This entrenched investor preference is also one factor amongst a patchwork of other drivers, both regulatory and non-regulatory, which are increasingly becoming identified as areas which should be targeted to boost activity on UK capital markets. As we have noted above, the provision of investment research tends to follow issuer and investor activity. Therefore, broader efforts to improve the attractiveness and competitiveness of UK capital markets are likely to stimulate a greater provision of investment research in the UK.

In this context, we note that several ongoing industry initiatives are seeking to channel a greater proportion of pension capital into UK equities. Alongside this, forthcoming FCA proposals will aim to boost the attractiveness of listing and raising capital on UK markets through changes to the UK Listing Regime and Prospectus Regime. These changes, along with many other policy initiatives geared towards generally improving UK capital markets, will be important to facilitating a greater level of investment research provision in the UK.

8. ***Have the UK 2022 revisions to the MiFID unbundling rules applicable to smaller quoted companies helped to facilitate investment research in relation to those companies?***
    - ***Have these revisions made it more likely that research firms will undertake research on smaller quoted companies?***
    - ***Is the £200 million market capitalisation threshold appropriate? If not, do you think that a size threshold is the most appropriate tool to incentivise research in smaller companies? If so, what should the level of the threshold be?***
    - ***For UK firms also operating in the EU, does divergence between UK/EU thresholds have an impact (for example affecting where they decide to do business)?***

Effectiveness of 2022 MiFIDII revisions

UK Finance and AFME members have not observed any material positive impacts on the provision of investment research in the UK following revisions made to the MiFIDII unbundling rules in 2022. The changes have in fact made the overall regime in some ways more complex.

Whilst the targeted relief sought by the 2022 revisions was well-intentioned, these measures have not reversed the challenges still faced by market participants.

£200m market capitalisation threshold

Our members believe that the broader concept of exempting research on companies below a defined market capitalisation from the requirement to unbundle research and dealing commissions is not conducive to improving the level of research coverage on smaller companies, nor to enhancing outcomes for the UK's wider research market and capital markets ecosystem.

Furthermore, UK Finance and AFME members have noted that the rules governing investment research in the UK do not often fully reflect the way in which research is produced or consumed. The current MiFIDII unbundling requirements generally consider research to be distinct pieces of analysis on a single company. This categorisation does not reflect the fact that much of the research produced by our members on, for example, 'smaller' companies, would out of necessity include comparisons to larger companies in the same sector that do not fall below the given market capitalisation threshold.

Given this tendency for investment research to combine many different aspects of the market, creating arbitrary divisions by way of thresholds – such as the sub-£200m exemption from the unbundling rules – can be an unhelpful feature of the UK's regulatory regime which creates additional complexity and cost for those accessing research.

International alignment

In the context of the regulatory and legislative environment for investment research, our members consider alignment with other international jurisdictions to be of primary importance to reflect the global nature of investment research provision.

UK Finance and AFME members agree that the regulation of investment research should prioritise outcomes for clients and the end-investor – an approach which facilitates greater global alignment could be more conducive to reaching these outcomes. To that end, we outline in response to Question 12 how this could be achieved through introducing a more flexible, client-focused approach to research payments in the UK; providing a broader level of optionality such that clients are empowered to choose how they pay for the research they consume (i.e. on a bundled or unbundled basis).

9. ***What might be the impact of any changes on the proposed UK legislative and regulatory environment on the provision and quality of research, the management of conflicts and payment for the provision of research?***

Global alignment

As noted in response to Question 8, we believe that to encourage investment in UK firms, and consumption of UK research, global alignment and the provision of a level playing field for firms operating globally into or out of the UK should be prioritised in any future changes to the UK's legislative and regulatory environment for investment research.

MiFIDII

Our members would not support any further technical amendments to the UK's existing MiFIDII unbundling rules if these were aimed at selective carve-outs, for instance for certain sectors or in respect of companies below defined size thresholds. These would be unlikely to have any positive consequences for the provision of investment research in the UK. Layering such regulatory changes could further exacerbate the complexity and operational cost pressures which market participants have adapted to since 2018 by way of significant investments in MiFIDII-compliant systems and processes. However, our members are supportive of a more comprehensive amendment to the rules which would introduce greater flexibility for all clients to choose how they access and pay for research, whether on a bundled or unbundled basis. Such decisions would be a matter for commercial agreement between research providers and their clients (see response to Question 12), and also a decision between a fund manager and their clients, as required by regulation.

10. ***Are there impediments (actual or perceived) to dialogue between UK listed or quoted companies and investment analysts that impinge the quality of research that should be considered and addressed?***

In responding to Question 1, we highlighted the importance of the communications and dialogue between analysts and companies that is associated with the production of investment research.

As described in response to Question 7, the UK has adopted a relatively strict regulatory approach to corporate access which can in some cases impede the dialogue between analysts and companies and have an impact on the quality of the research produced.

Specifically, the UK's rules can influence the nature of the dialogue between analysts and companies and thereby restrict the depth of information that analysts gather when 'in the room' with issuers. These impacts are of particular relevance for investment research produced on fixed income products.

Whilst objectively, the regulatory approach to corporate access is broadly consistent in the UK and the EU, the perception of clients as to how these rules are enforced and, for example, what constitutes a minor non-monetary benefit (MNMB) can differ between jurisdictions. This difference in approach can have consequences for the nature of the engagement between the buy-side, research analysts and companies in the UK.

11. ***Are there other impediments (actual or perceived) on the provision of research to investors – whether institutional or private – that should be considered and addressed?***

Members have no comments on this question.

12. ***What steps (legislative and non-legislative) could be taken to improve the provision and quality of research on UK listed and quoted companies?***
    - ***Please identify any advantages/ disadvantages and overall impact associated with any step you suggest***

Payment for research – Allowing greater optionality for clients

As noted in response to Question 8, UK Finance and AFME members agree that the UK's investment research market could benefit from the introduction of a more flexible regulatory approach to MiFIDII unbundling requirements. In essence, a broader level of optionality should be introduced such that clients are empowered to choose how they pay for the research they consume (i.e. on a bundled or unbundled basis), as opposed to this being determined by the size or sector of the company to which the research pertains.

This will allow clients to select the commercial model to consume UK research which is best suited to their needs and offered within a competitive market, whether this is driven by their business model, investment focus, end-investor needs, scale and budget, or home jurisdiction's regulatory framework.

Our members believe that such an approach could, in time, allow the investment research market to self-correct and the UK's research ecosystem to develop more naturally. Adopting a greater level of optionality could also bring simplification through reducing the operational costs and complexities of complying with the existing MiFIDII rules, and promote greater global alignment. In particular, we note that any negative impacts of the July 2023 expiry of SEC no-action relief for US broker-dealers receiving MiFID-compliant hard dollar payments for research would be lessened under the approach outlined above. We would also note in this regard the progress of respective policy discussions in other jurisdictions, which are considering the importance of greater optionality and client choice in payment for research.

Our members also recognise that the MiFIDII rules governing research are largely directed towards the activities of buy-side firms. This further highlights the importance of a flexible, client-based approach to research payments which prioritises outcomes for consumers of research and end-investors.

As part of any future changes, it is critical that all investment research is recognised as a valuable service that in all circumstances should retain optionality around compensation, on a bundled or unbundled basis.

UK Finance and AFME would welcome further discussion and engagement with the Investment Research Review, HM Treasury, and the FCA to explore how the approach proposed above could be implemented and operate in practice.

Corporate access, MAR, and COBS

As set out in response to Questions 7 and 10 (for corporate access), UK Finance and AFME members believe that there could be merit in identifying, reviewing, and where necessary refining areas of the UK's rules for corporate access, MAR, and COBS. Targeted changes could enhance the quality of the engagements which take place analysts and companies in connection with investment research and more generally to help the research ecosystem in the UK in line with the objectives of the Investment Research Review. Our members would welcome the opportunity to engage with the review and policymakers to explore these issues in further detail.

Issuer-funded / sponsored research

Our members have considered whether measures which would facilitate a greater level of sponsored research to develop in the UK could help to achieve the objectives of this review.

We note that there would be considerable challenges in successfully enabling an increased level of issuer-funded or sponsored research in the UK, most importantly in managing the associated conflicts of interests. In the view of our members, investors place a material value on the independence of the research they consume and therefore transparency would need to be a key feature of any regime.

Any move to facilitate sponsored research in the UK would need to be led by government and/or HM Treasury with the backing of key market participants and infrastructures. This form of research may also have associated international complexities, given that other jurisdictions may place different requirements on how sponsored research should be consumed.

We note that similar initiatives have been / are being attempted in other jurisdictions such as Australia, the US, and France. In 2022, French associations agreed to a charter of good practice for sponsored research, following recommendations made in 2020 to boost the level of sponsored research. Generally, our members have observed that efforts in these jurisdictions have faced difficulties in making sponsored research economically viable for market participants.

On balance, our members believe that focusing on enhancing the provision of *independent* research – particularly around prospective IPOs and new issuances. – is more likely to deliver better outcomes for investors and the UK's wider investment research market.