QUOTED COMPANIES ALLIANCE

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9 October 2014

Dear Sirs,

Financial Conduct Authority Discussion Paper DP14/3 – The use of the dealing commission regime

Introduction

We are the Quoted Companies Alliance, the independent membership organisation that champions the interests of small to mid-size quoted companies. Their individual market capitalisations tend to be below £500m.

The Quoted Companies Alliance is a founder member of European**Issuers**, which represents over 9,000 quoted companies in fourteen European countries.

The Quoted Companies Alliance Secondary Markets and Corporate Finance Expert Groups have examined your proposals and advised on this response. A list of members of the Expert Groups is at Appendix A.

Response

The effect on listed SMEs – availability of research

While we understand the FCA's aim to increase transparency on the way research is paid for, we strongly believe that the narrow focus of the FCA's proposal on transparency and client money will be to the detriment of small and mid-size quoted companies, which will be negatively affected by the full unbundling of research from dealing commissions.

At present, many small and mid-size quoted companies are only covered by one or two analysts and some are not covered at all. We believe the proposals put forward will decrease the amount of research available on small and mid-size quoted companies, and thus negatively affect their ability to raise finance, grow and create jobs.

The Quoted Companies Alliance agrees with the analysis in a recent Times article[1] that the proposal to unbundle research will have unintended consequences, such as fund managers narrowing down the number of companies from which they buy research and "in all probability, shrink the size of the research universe". It is pointed out that many companies, especially small and mid-size quoted companies, could

[1] Ian King (The Times, September 8)

stop being followed by analysts, which would lead to an increased difficulty in raising interest and therefore new investment in their activities. Access to equity finance is fundamental for the growth of small and mid-size companies in the EU and it should be encouraged, not hurdled.

Additionally, we believe that a reduced level of research will have a negative impact on the trading liquidity of UK small and mid-size quoted companies. This will lead to greater volatility and higher bid offer spreads for small and mid-size quoted companies, as a result of less research and fewer brokers in the market.

More broadly, the lack of available research will have a knock on effect on equity, fixed income and bond markets. We particularly note that a lack of research will most likely reduce market efficiency, given that research is the most efficient way to disseminate thoughtful company analysis and prompt discussion amongst market stakeholders.

This would also create higher barriers to entry, as smaller asset managers and brokers would be disadvantaged as a result of higher fixed costs and thus less access to research compared to larger competitors. The discussion paper estimates that around £1bn to 1.5bn per annum of dealing commissions was used by UK investment managers to acquire research in 2012. This compares with approximately £1.6trn of active equity assets under management, equivalent to around 7 basis points (bps), which would be seen as a relatively small cost saving for end investors, who would typically be seeking a long term return from equity of around 7%.

However, 7bps on an average revenue fee of around 70bps for an (equity) asset manager is approximately 10% of revenue. With a typical asset manager operating margin of around 35%, this cost could be close to a third of profit. The FCA's expected cost saving for investors is, therefore, unlikely to be realised, given the unintended adverse consequences of the proposals – namely inefficient markets due to a reduction in research and a significant shift in bid/offer spreads due to lower liquidity in the shares of small and mid-size quoted companies.

We have already stated in our response to ESMA Consultation Paper MiFID II/MiFIR (1 August 2014), that ESMA's proposals on legitimacy of inducements to be paid to/by a third person will have an adverse effect on small and mid-size quoted companies' ability to raise finance by reducing the research available on these companies. We have urged ESMA to reconsider their position on this and consider the detrimental impact this could have on growing companies which are essential for European economic growth. We are aware that some asset managers have expressed the view that the competitive disadvantage created by ESMA's (and the FCA's) proposals could lead to more asset managers relocating to outside of Europe (and, therefore, the UK). The FCA appears to be of the view that if it leads the way, then the world (i.e. the US and Asia) will follow. However, as the ESMA Stakeholder Group point out in its response to the ESMA consultation on this issue, "…it is unlikely that the US would consider a move to harmonisation on a global standard"[2].

The effect on the integrity of the UK market

We also agree with the Times article[3] that another likely but undesirable consequence could be that small and mid-size quoted companies will be forced to pay analysts to publish research on them to attract

[2] ESMA Stakeholder Group response dated 8 August 2014 (ESMA/2014/SMSG/035) paragraph 89.
[3] Ian King (The Times, September 8)

investor interest, which "regrettably, would be dismissed as little better than advertising" and result in additional costs being passed onto small and mid-size quoted companies (5.54).

The obvious outcome will be that such research will be less impartial and more advertorial, against the provisions and principles of the FCA's Conduct of Business Sourcebook. By contrast, research paid for collectively by investors through commission and reviewed by investment managers can reduce bias in company research and improve quality.

It is also possible that less research may lead to more market abuse and corporate misbehaviour. Companies and their management will be subject to a reduced level of independent scrutiny. Trading in the securities of such companies will be less liquid and more volatile. Both factors would tend to increase the likelihood of market abuse and decrease the probability of its detection.

The effect on the competitiveness of the UK market

The likelihood of small and mid-size quoted companies having to pay for research coverage will result in higher costs of coming to market and maintaining a listing. Added to increased share price volatility and reduced institutional access, this will culminate in companies questioning the value of a public listing.

Further, within the UK market, we believe that the reduction in the attractiveness of producing research would have negative consequences on competitiveness of other market participants. For example, we would expect less investment in small and mid-size quoted companies by smaller asset managers and that there will be pressure for small and mid-cap brokers to consolidate, resulting in less competition, against the FCA's competition principle.

Moreover it is also likely that the business models of brokers will change, with the main focus shifting to primary issues from secondary research. Such brokers will develop business models which, being more reliant on lumpier, more cyclical income, will make them risker market participants and ultimately this will be detrimental to the quality of the marketplace. This unintended consequence will in turn discourage any new entrants into the market, lowering competition

The views of the Quoted Companies Alliance are backed by a recent report[4], which explains that larger players and specialists are likely to remain at an advantage with these changes. Conversely, the economics for small research providers will become increasingly challenged, as they will be competing with larger players capable of offering multiple highly valued teams.

Within Europe itself, we understand that the FCA is attempting to reshape the UK dealing commission regime to align with future changes that will come in as a result of MiFID II. We would like to highlight that the MiFID II requirement is to unbundle *most* research from dealing commission arrangements, as mentioned in the discussion paper, and does not include *all* research, and carves-out 'widely distributed research' at the moment. Thus, the FCA's proposals in the discussion paper go much further than the changes required by MiFID II and could be seen as gold-plating EU legislation. This could put the UK market at a significant competitive disadvantage by adopting rules stricter than those to be applied (through ESMA) throughout European Union Member States. This is particularly significant given that the European

[4] Morgan Stanley and Oliver Wyman, cited by the FT (FT online, August 11)

asset management industry is heavily concentrated in the UK.[5] It also risks damaging the most significant and vibrant smaller companies' market in Europe.

Conclusion – the need for further analysis

We urge the FCA to re-consider their approach and conduct a thorough assessment, taking into account the analysis above and that of the ECSIP Consortium for the European Commission (DG ENTR) 'Improving the market performance of business information services regarding listed SMEs', mentioned in more detail below.

Responses to specific questions

Q1: Do you have any comments on our analysis on the potential impact of unbundling payments for research from execution arrangements, based on MiFID II proposals?

As said above, while we welcome the FCA's analysis of the current regime and assessing how firms can improve how research is bought under the existing rules, we believe that results of the study conducted do not thoroughly take into consideration the adverse impact this will have particularly on small and mid-size quoted companies.

Therefore, we disagree with 1.16, which states that the changes would "on balance, outweigh possible negative impacts". As pointed out in 1.31, changes under MiFID II will be subject to an impact assessment, which, we expect, will take into the consideration the issues faced by small and mid-size quoted companies; an appropriate impact/cost-benefit assessment specifically for small and mid-size quoted companies, which represent 85% of all UK quoted companies, should also be made by the FCA.

We disagree with the statement made in 1.33 regarding the liquidity of small and mid-size quoted company shares; it is our strong belief, from debating the issue with our constituency, that liquidity will be greatly affected. We would welcome a more thorough analysis of this point by the FCA, including a full analysis that quantifies the cost of the proposals to asset managers, brokers and companies – specifically unbundling large companies and small and mid-size companies, as they currently have different amounts of research and different levels of liquidity and trading volume.

Furthermore, we would welcome and encourage the FCA to engage in a wider debate on how to drive sustained improvements regarding valuation of research (4.11). In response to paragraph 4.67, it is true that many small and mid-size quoted companies have to rely on sponsored research. However, the FCA's proposals will decrease the already very limited research available on small and mid-size quoted companies, thus further exacerbating the current research issue for these companies.

In our view, the preferred option would be for the FCA to align with MiFID II and not consider adopting a narrower interpretation of the rules at this stage, but rather encourage ESMA to draw up less stringent rules which take into consideration small and mid-size quoted companies (5.30).

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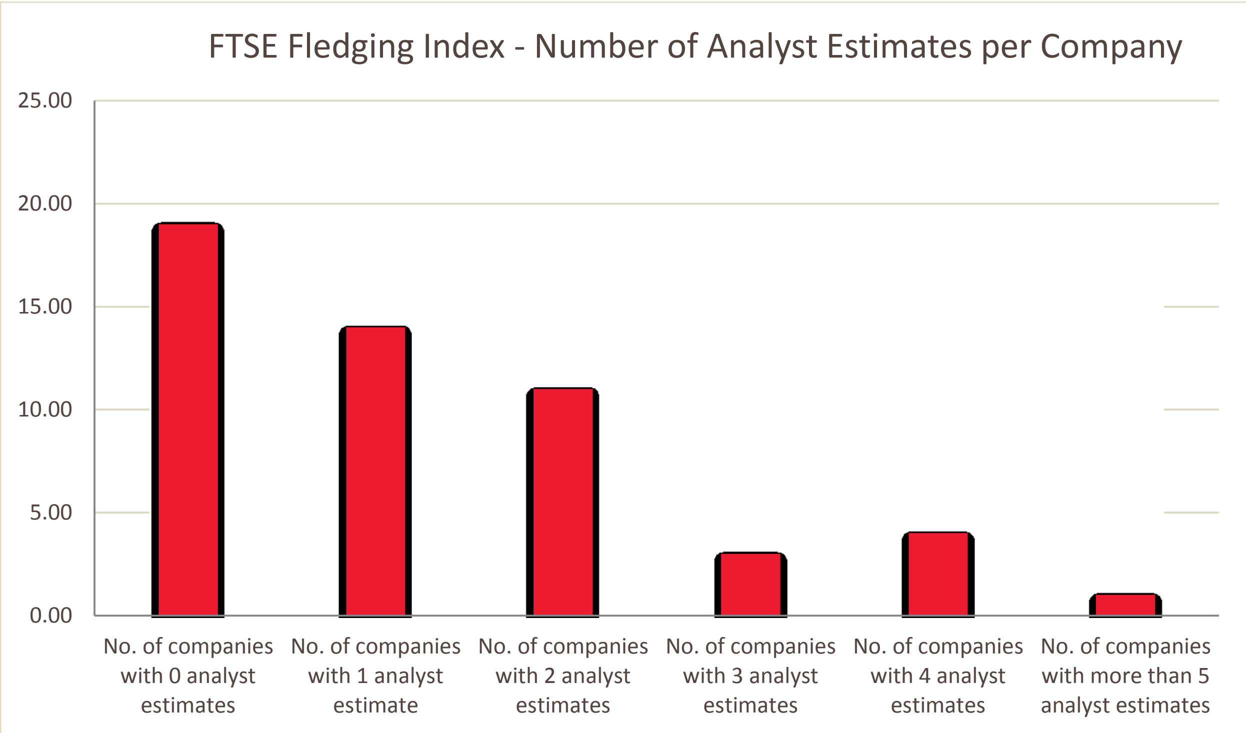
[5] The UK remains the leading centre for asset management in Europe with more assets under management (35%) than the next two largest centres (France and German) combined – see the Investment Management Association, "Summary of the IMA Annual Survey 2013-2014", September 2014.

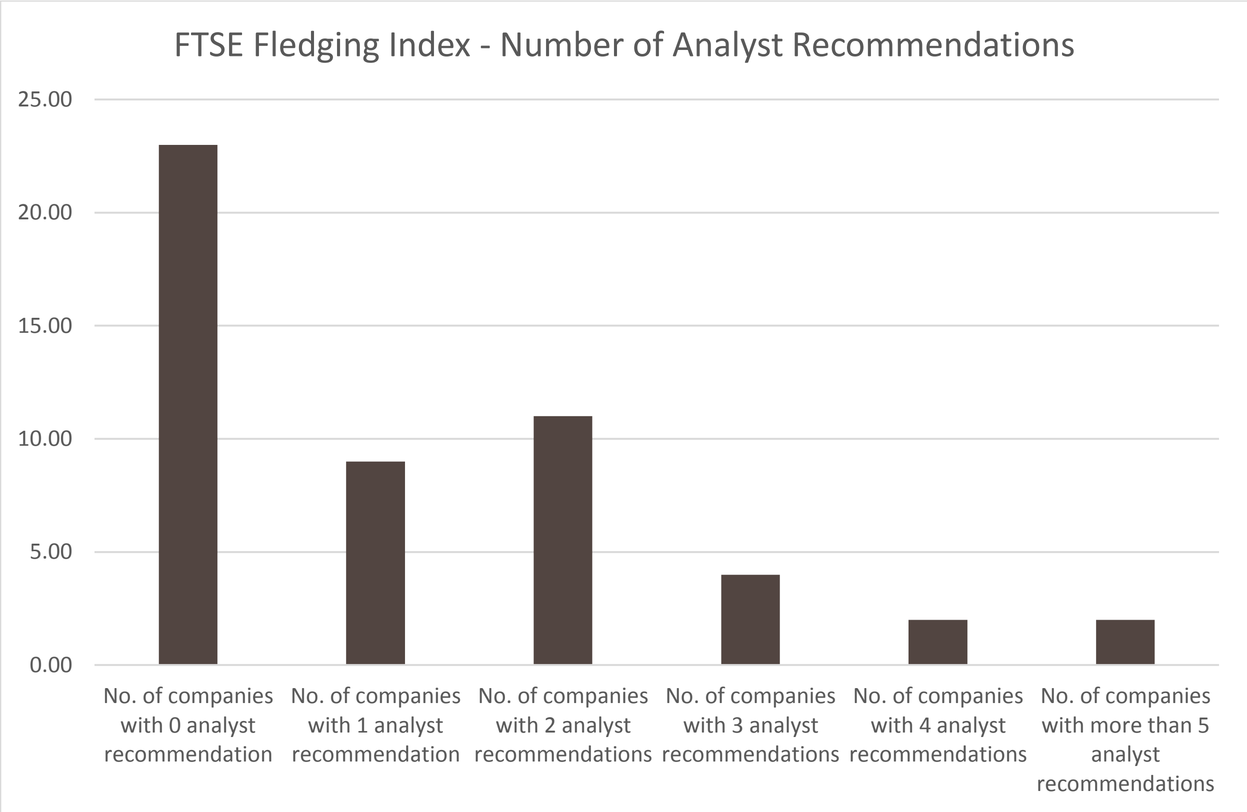
Q2: Do you have any analysis that would help inform our view of possible benefits or costs of extending requirements in MiFID II to cover all research goods and services?

We believe that a thorough cost/benefit analysis should be conducted by the FCA. We view the potential effect on liquidity as the greatest challenge of the FCA's proposals. Liquidity in small and mid-size companies' stocks could be dramatically affected by the loss of research and derived lack of confidence in the market. This should be carefully assessed.

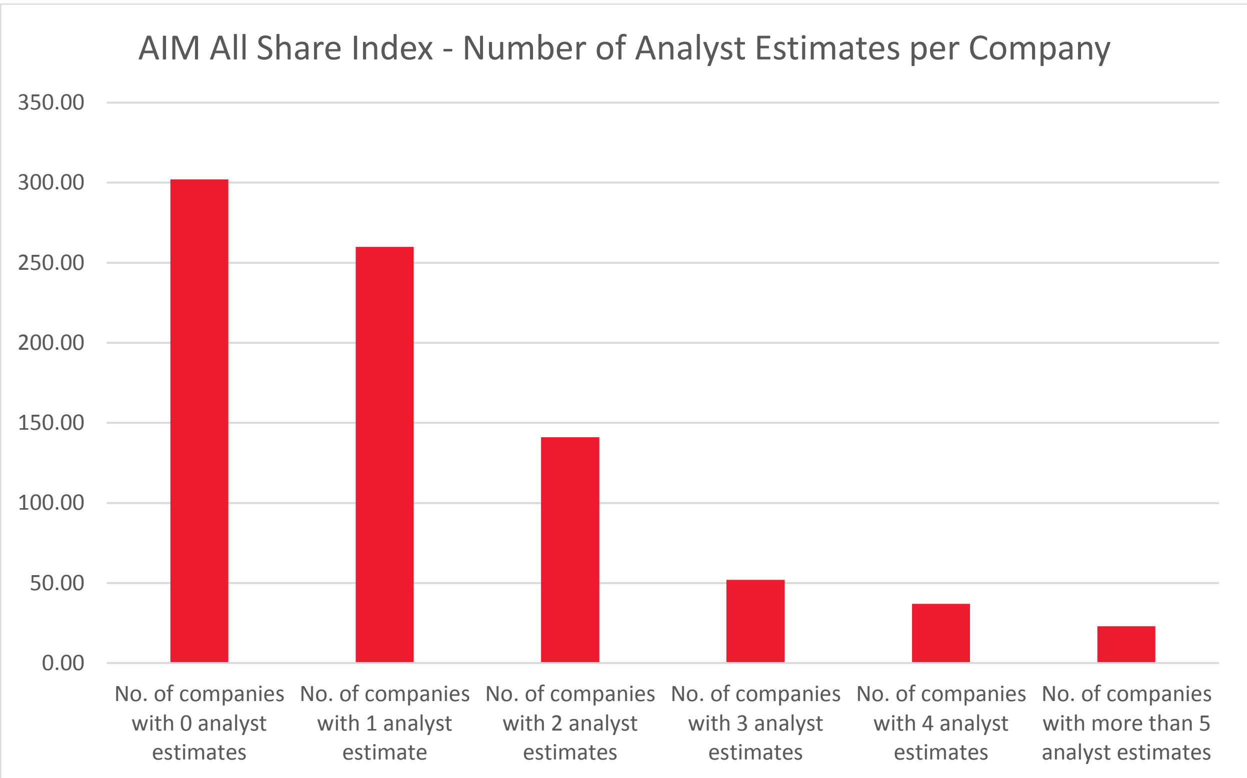
As mentioned earlier, research coverage of small and mid-size quoted companies is already very limited. We have included below some analysis of the amount of analysts covering small and mid-size quoted companies at the moment, which illustrates this point:



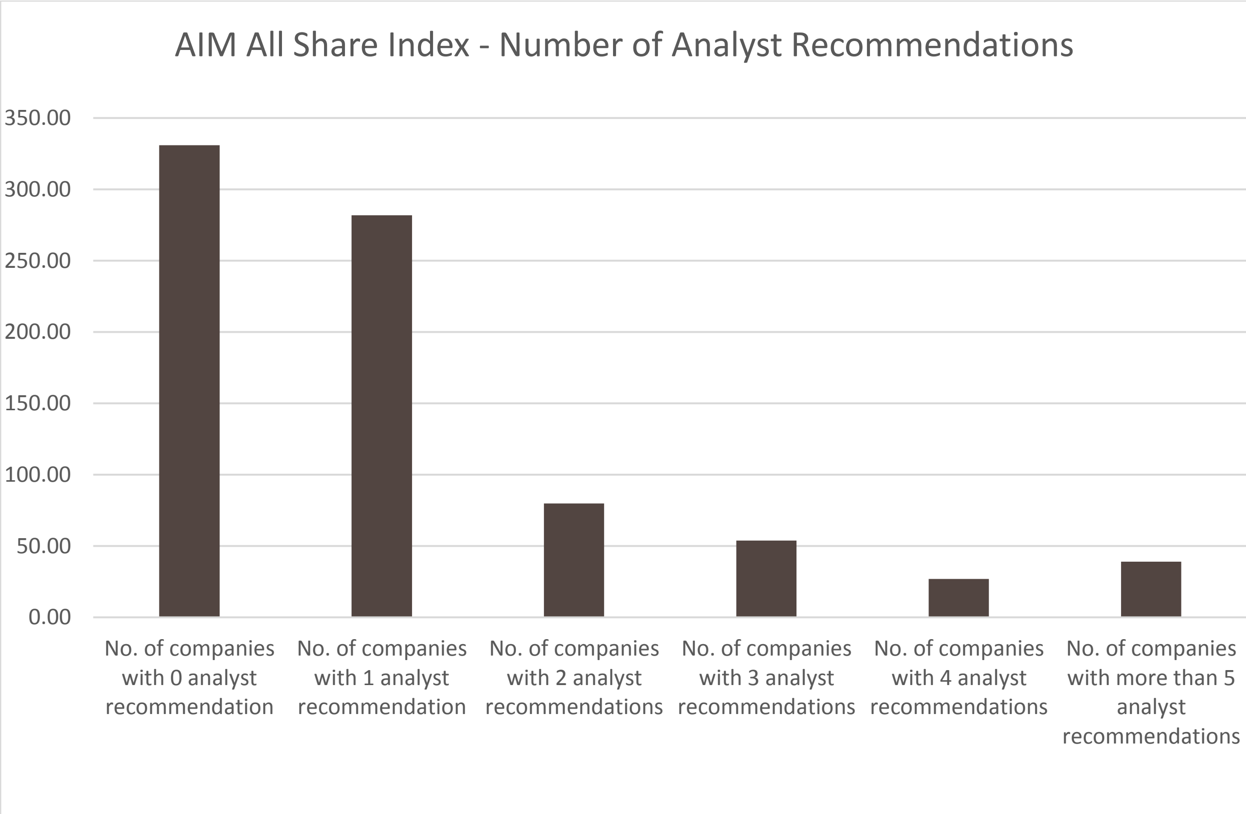
Source: Bloomberg (as of 2 October 2014)



Source: Bloomberg (as of 2 October 2014)



Source: Bloomberg (as of 2 October 2014)



Source: Bloomberg (as of 2 October 2014)

Also, we believe that the findings of the report made by ECSIP Consortium for the European Commission (DG ENTR) 'Improving the market performance of business information services regarding listed SMEs'[6] should be taken into consideration in the FCA's analysis. As mentioned in the study:

> *Under the current economic model, the illiquid nature and the low level of market capitalisation of SMEs, small- and mid-cap stocks will always act as a barrier for brokers to produce research and investors to invest. The cost of hiring research analysts is considerable for both institutional investors and brokers; they both need to generate enough fees to cover the cost of research. The illiquidity of small and medium companies makes it harder for brokers to generate enough commission via trading to warrant covering a stock,* and

> *The demand for business information on large firms is much higher as are the fees that can be generated. The costs to provide research are the same for small and large firms but the ability to generate fees in small companies is much less.*

The report also mentions some of the negative impacts of policy on research, including the provision of business information on listed SMEs, and includes in its medium-term recommendations for regulatory change:

> *The characteristics of SME companies differ significantly from large cap companies. This also affects the business models of financial market participants who specialise in dealing with SMEs. Caution*

[6] 'Improving the market performance of business information services regarding listed SMEs', September 2013 (http://ec.europa.eu/enterprise/newsroom/cf/itemdetail.cfm?item_id=7562&lang=en&title=Improving-the-market-performance-of-business-information-services-regarding-listed-SMEs)

> *should be used when making broad "one size fits all" policies that may affect for example liquidity provision, the bundling or unbundling of products and information, corporate access and dark pool trading. It may be useful to consider carve outs for SMEs and those that provide services in this sector*
>
> *Unbundling of brokers' services should stimulate the establishment of independent research analysts. However, the true nature of unbundling needs to be fully understood and in most jurisdictions, even the UK, is not fully implemented which may in turn hinder the emerging business models*

If you would like to discuss any of the responses in more detail, we would be happy to attend a meeting. We would also be happy to provide the FCA with practical examples supporting our views and to facilitate discussions with small and mid-size quoted companies, fund managers and market makers working with small and mid-size quoted companies.

Yours faithfully,

Tim Ward
Chief Executive

APPENDIX A

Quoted Companies Alliance Secondary Markets Expert Group

Simon Rafferty (Chairman)	Winterflood Securities Ltd
Mark Tubby	finnCap
Fraser Elms Katie Potts	Herald Investment Management Ltd
Claire Noyce	Hybridan LLP
Peter Swabey	ICSA
Brian McDonnell	Olswang
Mitchell Gibb Sunil Dhall	Peel Hunt LLP
Jon Gerty	Shore Capital Group Ltd
Andrew Collins Paul Arathoon William Garner	Speechly Bircham LLP
James Stapleton	Winterflood Securities Ltd

Quoted Companies Alliance Corporate Finance Expert Group

Samantha Harrison (Chairman)	RFC Ambrian Limited
Richard Evans	Strand Hanson Limited
Nick Naylor	Allenby Capital Ltd
Chris Hardie	Arden Partners PLC
Jonathan Morris	Bates Wells & Braithwaite LLP
Chris Searle	BDO LLP
Amerjit Kalirai David Foreman Mark Percy	Cantor Fitzgerald Europe
Martin Finnegan	Causeway Law
Stephen Keys	Cenkos Securities PLC
Sean Geraghty	Dechert
Stuart Andrews	finnCap
Colin Aaronson	Grant Thornton UK LLP
Laurence Sacker	UHY Hacker Young
Maegen Morrison Robert Darwin	Hogan Lovells International LLP
James Green	K&L Gates LLP
Richard Crawley	Liberum Capital Ltd
David Bennett Simon Charles	Marriott Harrison
Richard Metcalfe	Mazars LLP
Lesley Gregory	Memery Crystal LLP
Nicholas Narraway	Moorhead James
Kristy Duane	Nabarro LLP
Dalia Joseph	Oriel Securities Limited
Jonathan King	Osborne Clarke
Daniel Harris	Peel Hunt LLP
Leighton Thomas	PricewaterhouseCoopers LLP
Charles Simpson	Saffery Champness
Azhic Basirov	Smith & Williamson LLP
Mark Brady Neil Baldwin	SPARK Advisory Partners