Quoted Companies Alliance proposals to amend ESMA's Technical Advice to the Commission on MiFID II and MiFIR (ESMA/2014/1569) regarding investment research:

- **Introduce proportionate requirements, specific for those firms specialising in SME research and based on the principles of transparency, best execution and quality of research;**
- **Introduce a more flexible clients' agreement on cost allocation** (in lieu of the proposed research budget), ensuring that criteria to assess the clients' needs for research and criteria to deduct research charges are in place; and
- **Allow investment firms to be able to agree with executing brokers that financial research could be paid by dealing commissions**, so long as strict conditions are in place.

Justification

1. Why is investment research important for small and mid-size quoted companies?

Research is valued by companies as a service that enhances the quality of the portfolio management by increasing the asset managers' ability to access varied research and different perspectives. Research coverage increases visibility and trading in small and mid-size quoted companies' shares, thus enhancing liquidity and enabling growth.

2. The negative effects of ESMA's Technical Advice on MiFID II on small and mid-size quoted companies

ESMA's technical advice on inducements and investment research would have a negative effect on small and mid-size quoted companies' ability to raise finance, grow and create jobs. It will decrease the amount of research on quoted SMEs (which is already minimal), thus decreasing their visibility and potentially limiting investment.

As a result of less research and fewer brokers involved in the small and mid-size quoted company market, the proposed rules will lead to lower liquidity, greater share price volatility and higher bid offer spreads. This will result in higher costs associated with raising finance and reduced institutional access, which could culminate in companies questioning the value of being listed on a public equity market.

A recent Peel Hunt and Extel Survey[1] found that:

- 85% of buy-side respondents fear there will be a decrease in the number of analysts publishing on small and mid-size quoted companies.

[1] 'Unintended Consequences' November 2014, available here: https://www.extelsurveys.com/Panel_Pages/PanelPagesBriefings.aspx?FileName=Peel_Hunt_Extel_Unintended_Consequences_November_2014

- 74% believe that the proposals will adversely hit liquidity of small and mid-size quoted companies' stocks.

- 84% of buy-side respondents believe that the MiFID II proposals will affect the ability of small and mid-size quoted companies to access capital markets due to the reduction in liquidity driven by reduced sell-side research coverage.

- 78% of quoted companies responding see a correlation between the number of analysts writing on their company and the liquidity of their shares.

We anticipate that the costs of research will increase and the volume and scope of research will fall, which will result in small and mid-size quoted companies finding raising capital more difficult and reduce trading liquidity due to little research coverage.

There also will be higher barriers to entry in the investment market. Smaller asset managers would be disadvantaged regarding fixed costs and access to research compared to larger competitors. According to the Peel Hunt and Extel Survey, 84% of buy-side respondents think MiFID II proposals will raise barriers to entry for new asset managers to start up and force further consolidation giving the consumer less choice. As for existing asset managers, 86% believe that there will be a greater impact on smaller asset managers compared with the larger managers.

3. Inconsistencies in ESMA's Technical Advice on inducements and investment advice

We believe that the definition of investment advice is likely to impact on ESMA's proposals in relation to dealing commission/unbundling.

MiFID I defines investment advice as the provision of a personal recommendation to a client[2]. According to its implementing directive, a recommendation is "not a personal recommendation if it is issued exclusively through distribution channels or to the public"[3]; however, ESMA's Technical Advice is that the words "through distribution channels or" should be removed.[4]

As put forward by ESMA, research would have to meet one of two standards to not be considered an inducement:

- it could be a personal recommendation to each client who reads it; or

- the firm could make the research available to the public.

Investment research typically contains a personal recommendation to a client[5]; it is an essential part of the definition that research is only truly valuable if it does contain a conclusion upon which the reader can act.

The universal reason put forward as to why investment research does not currently amount to a personal recommendation is because research is sent "thorough distribution channels" by a firm to

[2] Article 4 (1) (4)
[3] Article 52 of the MiFID I Implementing Directive
[4] Section 2.2 of the Final Report, 19 December 2014
[5] For instance, it suggests that a company is a "BUY".

its clients. That is partly because the audience for the research is the clients of the firms and partly because distribution of research is often restricted.[6]

Under ESMA's Technical Advice, research could be a personal recommendation to each client who reads it. That is unworkable, as the firm will not be able to distribute research if it is required to personally tailor the research to each recipient based upon the advice that has been gathered. Research, at the moment, puts forward a view on a company that is not based upon a detailed understanding of the needs of each recipient, rather upon the general stance of a whole group of likely recipients.

The other alternative proposed by ESMA is to make the research available to the public. There are three factors that also make this highly problematic:

- This approach would run completely contrary to the advice by ESMA relating to research and inducements. This suggests that research should, in fact, be "sold" to fund managers, rather than provided as part of a bundled commission. It would be impossible to persuade any fund manager to buy research that was made available to the public for free in order to comply with the requirements on personal recommendations.

- Making it available to the public generally might breach prohibitions on the distribution marketing into overseas jurisdictions.

- All research would need to be produced to the standards of a retail client or an unsophisticated audience. This would mean that firms would not be able to produce research for a professional client-base, who would not want to have the language written in an entirely non-technical way.

4. <u>The particular case of small and mid-size quoted company research</u>

At the moment, brokers specialising in small and mid-size quoted company's stocks mostly produce research on the securities of companies with which they have or are seeking a corporate relationship that is distributed widely to those investing in small and mid-size quoted companies in order to raise the profile of the researched companies. The stockbroker contracts with the companies to produce and distribute this research, among other services including arranging road-shows ("corporate access") with institutional investors. The retainer income the broker receives under these contracts represents its payment for producing the research.

Conversely, brokers that specialise in large quoted companies' stocks produce research speculatively on companies with which they have no corporate relationship that is distributed to their institutional stockbroking clients in order to induce said institutions to trade via the broker. The secondary commission thus generated represents the stockbrokers' payment for producing the research.

The principal purpose of stockbroker-produced research on small and mid-size quoted companies is not an attempt to garner ("induce") secondary trading commission. It forms part of the broader

[6] For instance, research can be restricted in overseas jurisdictions or not available to retail clients etc.

marketing/investor relations efforts of small and mid-size quoted companies, which is paying the broker for the research amongst other marketing/IR services, including corporate access.

In limiting and conditioning the ability of brokers to specialise in small and mid-size quoted company's stocks, the proposed regime in ESMA's Technical Advice would effectively limit the ability to promote and give visibility to those stocks, ultimately harming small and mid-size quoted companies. It may even lead to an increase in market abuse and a fall in transparency levels.

5. Proposed solutions

- **Introduce proportionate requirements, specific for those firms specialising in SMEs stocks' research and based on the principles of transparency, best execution and quality of research:**

    - Research on any company with a market capitalisation below EUR 200 million – either quoted on an SME Growth Market or listed on a regulated market – should be exempt from the requirements defined for investment research.

- **Introduce a more flexible clients' agreement on cost allocation** (in lieu of the proposed research budget), ensuring that:

    - Investment firms monitor the quality of research and ensure best execution by the executing brokers (who must provide the firm with detailed information);

    - Internal administrative procedures are set up by the investment firm in order to duly assess the clients' needs for third party research;

    - Clients are informed of the criteria to deduct research charges (firms providing execution services should disclose clearly the amount of commissions of trading fees for those services).

- **Allow investment firms to be able to agree with executing brokers that financial research could be paid by dealing commissions**, so long as:

    - It has been agreed in advance the proportion allocated to remunerate the financial research;

    - The amount of the dealing commissions reflects the quality of the research services;

    - Clear internal administrative procedures have been established to preserve the allocation criteria agreed with each client; and

    - The amount allows the firm to comply with its best execution principles (Art. 27 MiFID II).