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Wednesday 5 June 2024

Dear FCA colleagues,

Payment Optionality for Investment Research: Consultation Paper

We welcome the opportunity to respond to your consultation on Payment Optionality for Investment Research.

The Quoted Companies Alliance *Primary Markets* and *Secondary Markets Expert Groups* and *Investor Working Group* have examined the proposals and advised on this response from the viewpoint of small and mid-sized quoted companies. A list of Expert Group members can be found in Appendix A.

We welcome the FCA's consultation in this area, and the broader efforts of reform of the investment research infrastructure catalysed by Rachel Kent's Investment Research Review. At the QCA, we recognise the importance of nurturing a healthy investment research eco-system as this is vital for effective price-discovery, facilitating liquidity and securing fair valuations. The fundamental issues caused by unbundling as part of MiFID II, particularly for small and mid-sized quoted companies, are well recognised in terms of their adverse impact on the quality and quantity of coverage for these companies which in turn has depressed liquidity in these stocks.

We support the FCA's proposals for introducing payment optionality for investment research as part of the effort to improve the quantity and quality of research in UK equity markets.

However, as a general observation, we would like to note that retrospectively removing or adjusting rules and requirements once they have been applied can create challenges and be costly to implement. For this reason, and going forward, it is important to ensure that the implications of rules and requirements are considered thoroughly by the regulator prior to implementation, including in relation to any unintended consequences they may produce. This will result in improved market outcomes for all participants and help prevent retrospective adjustments that can be time consuming and costly. Given that the business models of intermediaries have adapted as a result of the implementation of MiFID II, it may take time for them to revert to practices that predate the rules. As such, we encourage the regulator to work in conjunction with government to progress other reforms in this area.

It is our view that the introduction of other recommendations set out in the Investment Research Review, including the creation of an investment research platform, and a Code of Conduct for investment research – as we discuss below - are necessary steps in increasing research coverage for growth companies and improving liquidity in these stocks.

Regarding the associated guardrails, it is important that they are not overly onerous. A proportionate and flexible approach in this area is vital to ensuring that the new payment option is utilised by market participants so that the potential benefits of the new reforms are realised. Furthermore, it is essential that the UK is in alignment with other international markets, in particular the US and EU, as this will help the UK remain internationally competitive in accordance with the FCA's secondary competitiveness objective.

If you would like to discuss our response in more detail, please do not hesitate to contact us.

Yours sincerely,

James Ashton.

James Ashton
Chief Executive

Q1 Do you agree with our proposal to create additional payment optionality for investment research?

Yes – in principle, we agree with the FCA's proposal to create additional payment optionality for investment research. However, as stated in the introduction, given that the business models of intermediaries have adjusted as a result of these rules, we do not anticipate that these changes will have an immediate impact in the short to medium-term.

It is well recognised that the changes implemented as part of MiFID II, specifically around the unbundling of research costs from those of execution costs have negatively impacted the provision of investment research in the UK. We believe that this has been particularly pronounced for research on smaller companies. While on its own, the introduction of unbundling is not responsible for the current crisis of de-equitisation that is affecting the UK's public markets, its impact has been wide-reaching.

In particular, low provision of investment research, particularly for smaller stocks, has had an adverse impact within these securities. As the Investment Research Review made clear:

> "the most significant feature of analyst coverage in the UK, in common with all other comparable international financial services centres, is the difference in coverage of larger cap companies (in broad terms, but with exceptions, companies having a market capitalisation in excess of £1 billion) compared to smaller cap companies. The larger cap companies are generally well served by analyst coverage, whereas the smaller cap companies are not."[1]

Given that 81% of quoted companies have a market cap below £1bn[2], it is vital that this situation is rectified in order to boost liquidity, reduce the cost of capital for growth companies and enhance the UK's overall competitiveness.

We believe that allowing payment optionality could potentially result in greater research budget flexibility for buy-side firms, help to increase new entrants to the market thereby enhancing competition, choice and overall coverage. We anticipate that this would boost access to research and its overall scope resulting in an increase in the amount of investment research that is produced, particularly for small and mid-cap companies.

Q2 Would you be likely to take advantage of the proposed new payment option?

The QCA is a trade body that represents the interests of small and mid-sized quoted companies and the firms that advise them. We hope that these firms will use the new payment optionality however we believe that more needs to be done to encourage its use.

Q3 Do you have any views on key indicators that could act as success measures for the outcomes we are looking to achieve?

We agree with this consultation's suggestion of measuring whether there has been an increase in research production as a result of these changes. We would like to further this suggestion by adding that this could be

[1] Kent, R. *UK Investment Research Review*. (2023). p4.
[2] Data from London Stock Exchange (LSE) demonstrates that, as of April 2024, across both the Main Market and AIM there are 1429 companies in the £0-1bn market cap. range of a total 1764 companies. Taken from: LSE (2024): Main Market Factsheet April 2024. and AIM Factsheet April 2024.

broken down according to market cap. in order to determine whether the reforms are having the desired impact, particularly for small and mid-caps where research coverage is lower than their larger counterparts.

In addition to the above, the following possible measurements would be beneficial:

- Analysis of whether there has been a perceived improvement in the quality of research that has been conducted.
- The average amount of analysts working a particular company, broken down according to market cap.
- The impact of these changes on levels of liquidity, particularly at the small and mid-cap end of the market.

Q4 Is the proposed new payment option and associated guardrails likely to be more efficient and adaptable than existing options for small, fast-growing or new entrant firms, or for existing users of RPAs?

Yes – we believe that the new payment option and associated guardrails are likely to be more efficient and adaptable than existing options for small, fast-growing or new entrant firms, or for existing users of RPAs. Moreover, introducing the new payment option should boost competition and increase choice across the market.

Overall, the use of RPAs is not as widespread as the alternative P&L option. The adoption of the P&L model is difficult for new entrants and smaller firms as they do not have the capacity to pay for the research out of their own resources compared to larger firms. As a result, most smaller firms use the RPA model which is difficult to operate and resource intensive for the firms that use them. This is due to firms having to develop the necessary infrastructure to track and monitor their research consumption, including research budgets and the requirement to allocate research across diverse funds, alongside the risk of potential fines for non-compliance[3].

Q5 Do the guardrails we are proposing around firms' use of the proposed payment option secure an appropriate degree of protection for consumers?

It is important that the guardrails strike the right balance between ensuring flexibility and securing greater consumer protection and transparency. If the new payment option and associated guardrails are to be successful, it is vital that they are proportionate and that reporting requirements are not unnecessarily burdensome for firms. Otherwise, use of the new payment option will likely be reduced and its benefits will not be fully realised.

The guardrails should ensure that the information that firms produce provides clients with information on the guiding principles regarding how firms utilise third-party research to the benefit of their clients. It is important that disclosures that firms are required to present are straightforward and do not necessitate overly granule information being produced. Provided that the budget setting process outlined as part of the guardrails is implemented, this should mean that overly burdensome reporting obligations are not required.

[3] Tata, F. *Explaining asset managers preference for the P&L method over RPAs when paying for research under MiFID II.* (2019).

Furthermore, we believe that cost disclosures should form part of a firm's ordinary regime for making fee disclosures, instead of being listed as a discrete item. In addition, any audit requirement ought to be in line with the firm's broader requirement to produce audited accounts.

We also propose the development of a Code of Conduct for sponsored research as recommended in the Investment Research Review. This would improve the validity, reliability and transparency of investment research. The Code of Conduct would determine how sponsored research is issued and regulated, and could cover issues such as frontrunning, payments, publication and other arrangements. This would alleviate some of the uncertainties around sponsored research and increase levels of confidence in this type of research, establish good practice and provide additional safeguards for consumers in sponsored research.

We believe that the QCA is well-positioned to run this new code given our track-record of producing a range of codes for smaller growth companies, including the QCA Corporate Governance Code which is adopted by 93% of AIM companies and a large portion of Standard List companies[4].

Q6 Is the proposed new payment option and associated guardrails likely to facilitate operational efficiencies via increased alignment with the requirements of other jurisdictions when purchasing research from overseas providers?

It is important that the UK is not at a competitive disadvantage with other international markets. Introducing payment optionality for investment research will ensure that the UK is aligned with its global competitors, in particular the US where paying on a bundled basis is the norm. In addition, the EU has announced a proposal that will see a return to the re-bundling of investment research fees and execution costs for companies under a £10bn market cap.[5] In addition, the introduction of payment optionality would eliminate barriers to UK buy-side firms that source research from other jurisdictions where payment on a bundled basis is standard practice, for example, the US.

Q7 Do you agree with the findings set out in the Analysis section of this consultation paper?

We have no comments.

Q8 Are there any features of the proposed payment option and associated guardrails that would positively or negatively impact its take-up by firms?

Please see our response to Q5 regarding our views on the requirements set out by the guardrails.

Q9 Do you agree with the proposed addition of short-term trading commentary and advice linked to trade execution to the list of acceptable minor non-monetary benefits in COBS 2.3A.19R(5)?

We have no comments.

Q10 Do you agree with the deletion of the option for bundled payments to purchase research on companies with a market capitalisation below £200 million from the list of acceptable minor non-monetary benefits in COBS 2.3A.19R(5)?

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[4] The Quoted Companies Alliance. *Good governance and growing influence.* (2023).
[5] Amending Directive 2014/65/EU to make public capital markets in the Union more attractive for companies and to facilitate access to capital for small and medium-sized enterprises and repealing Directive 2001/34/EC. (2024). Available here: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0760

Yes – we agree the FCA's proposal in this area as it will reduce complexity and improve certainty around the proposed changes.

Q11 Are there any further comments you wish us to consider while finalising these proposals? If so, please include here.

We have no comments.

Q12 Do you have any comments on our cost benefit analysis?

We have no comments.

Q13 Do you hold any information or data that would allow assessing the costs and benefits considered (or not considered) here? If so, please provide them to us.

We have no comments.

Appendix A

The Quoted Companies Alliance *Primary Markets Expert Group*

Samantha Harrison (Chair)	**Grant Thornton UK LLP**
Colin Aaronson	Grant Thornton UK LLP
Stuart Andrews	Zeus Capital
Mark Brady	Spark Advisory Partners Limited
Andrew Buchanan	Peel Hunt LLP
David Coffman	Novum Securities Limited
Richard Crawley	Liberum Capital Ltd
Dru Danford	Liberum Capital Ltd
David Foreman	Zeus Capital
Chris Hardie	W.H. Ireland Group PLC
Stephen Keys	Cavendish
Nick McCarthy	Shoosmiths LLP
Katy Mitchell	W.H. Ireland PLC
Hayley Mullens	Radnor Capital Partners Limited
Nick Naylor	Allenby Capital
Jeremy Osler	Cavendish
Niall Pearson	Hybridan LLP
Mark Percy	Shore Capital Group Ltd
Oliver Pilkington	Shoosmiths LLP
George Sellar	Peel Hunt LLP
James Spinney	Strand Hanson

The Quoted Companies Alliance *Secondary Markets Expert Group*

Amber Wood (Chair)	**Liberum Capital Ltd**
Jasper Berry	Cavendish
Andrew Collins	Charles Russell Speechlys LLP
Sunil Dhall	Peel Hunt LLP
Nick Dilworth	Winterflood Securities Ltd
Fraser Elms	Herald Investment Management Ltd
Richard Fenner	Euroclear UK & International
William Garner	Charles Russell Speechlys LLP
Jon Gerty	Peel Hunt LLP
Alex Giacopazzi	Winterflood Securities Ltd
Mitchell Gibb	Stifel
Keith Hiscock	Hardman & Co
Niall Pearson	Hybridan LLP

Jeremy Phillips	CMS Cameron McKenna Nabarro Olswang LLP
Katie Potts	Herald Investment Management Ltd
Chris Robinson	Peel Hunt LLP
Stephen Streater	Blackbird Plc
Peter Swabey	C/o The Chartered Governance Institute

The Quoted Companies Alliance *Investor Working Group*

Paul Stevens (Chair)	**Business Growth Fund (BGF)**
Fraser Elms	Herald Investment Management Ltd
James Goodman	Schroders Investment Plc
Judith Mackenzie	Downing LLP
Katie Potts	Herald Investment Management Ltd
Richard Power	Octopus Investments
Eustace Santa Barbara	Canaccord Genuity
Gervais Williams	Premier Miton Group Plc