UK Investment Research Review
HM Treasury
1 Horse Guards Road
Westminster
London
SW1A 2HQ

By email

June 2023

FCA Markets Practitioner Panel (MPP) and Listing Authority Advisory Panel (LAAP) formal response to Call for Evidence UK Investment Research Review

Dear Ms Kent,

We welcome the opportunity to contribute to the discussion on UK Investment Research and are supportive of the Review's objective, assessing the provision of investment research and its contribution to the competitiveness of the UK's capital markets.

MPP and LAAP Joint Response – UK Investment Research Review

MPP is an independent statutory panel that the FCA is required to establish and maintain under FSMA. It advises the FCA on policy issues, regulatory proposals and other strategic matters that are likely to affect wholesale financial markets. LAAP is an independent non-statutory*[1] panel that advises the FCA on policy issues which affect issuers of securities, and on policy and regulation proposals from the FCA listing's function.

The FCA Board appoints Panel Members and not as representatives of any individual firm; they are expected to contribute to the respective panels from the perspective of wholesale and securities markets or the primary market sub-sector in which they are working, drawing on their personal experience and industry sentiment more generally.

This joint response reflects views widely held by LAAP and MPP Members and does not necessarily imply unanimity. In one area in particular, Members hold differing opinions and we have included both as they reflect perspectives within the wider industry. We have not answered every specific question, rather we have focused on some key areas.

[1] *The status of LAAP is expected to change to 'statutory' during 2023, under provisions within the Financial Services and Markets Bill.

Executive summary

To open our response, we would like to make the point that we observe several issues for the UK capital markets of which the level of research coverage is but one important aspect.

Investment research is a key part of this eco system and helps to underpin a well- functioning market. Good research helps investors understand the growth prospects of issuers and how the issuer's prospects should be valued (thus helping with price formation both at IPO and in secondary trading). As a result, the availability of high-quality research is a necessary condition of a successful public market. However, improving the provision of research on its own is not sufficient to address the issue of the UK's declining public market and needs to be combined with other regulatory reforms and a general shift in mindset by market participants.

The other areas to that require addressing are Listing venues, depth of the market, and valuation comparator. The issues have developed over time and are manifested in a shrinking number of listed companies. We recognise that reviews are already underway on Listings venues and that there are multiple factors that impact depth of the market and valuation comparator. We would therefore encourage the review to liaise closely with the FCA and other stakeholders.

Over recent years there has been a significant drop in the level and quality of research coverage in the UK market. This has been a particular issue in the midcap and small-cap space as well as in particular growth areas such as technology the very area where the UK wishes to grow its presence. Research divisions in the major banks tend to be loss making, meaning that research houses either cover very liquid stocks or need a corporate finance relationship to justify the research expense. In addition, UK-focused research desks are often being merged with EU desks which negatively impacts UK mid cap stocks. The focus on costs also means that there is a general lack of senior, very experienced analysts as well as analysts often having to cover an ever-wider range of companies which necessarily impacts quality of individual company research.

MIFID II unbundling rules have been a factor. Research payments have fallen materially since the introduction of MiFID II and since January 2018, European brokers have shrunk their analyst teams at least three times more than their US counterparts. Reform of the unbundling rules needs to be looked at as well as other opportunities to rebuild the quality and extent of research coverage in the UK capital markets.

However, we cannot simply attempt to "put the genie" back in the bottle and revert to the previous framework for a number of reasons These include the fact that the MIFID changes did produce greater and necessary transparency, that MIFID is not the only piece of regulation that affects research provision, and that the international regulatory framework has changed and will likely change again. Investment Research is a global industry, and it is vitally important that we look to achieve international alignment rather than moving backwards alone.

There are a number of options and opportunities that could be pursued, including greater cooperation with leading expertise in academia or sponsored research, noting that such research would need to have appropriate independence safeguards in place as well as looking at exemptions to unbundling at certain market capitalisation levels (to ensure a level playing field with the EU which is proposing an exemption on unbundling below Euro 10bn market capitalisation) or exemptions for certain high growth industries.

Response to individual questions

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

MiFID II unbundling rules were well intentioned and delivered on objectives to increase transparency on costs and reduce overpayment for repetitive or mediocre research. The regime changes also resulted in some negative consequences, with a notable reduction in the provision of research in both the UK and the EU and in particular, on the coverage of smaller companies and sectors focused on innovation. Research providers are not incentivised to maintain coverage of small & mid-cap companies and often provide limited information on the companies that they do research. The economic case for research is increasingly marginal in small & midcap companies given limited commissions and investment banking revenues. A shift in pension fund allocations away from equities and into international markets has exacerbated the impact on provision of research on UK companies and the drive to internationalise portfolios has raised liquidity requirements, which has resulted in further reduction in emphasis on UK mid & small-cap companies.

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.**

Research when produced continues to be of good quality. However, as noted above, research providers have retreated from covering smaller companies and some sectors. The decline in research coverage has been gradual since 2014 and then the introduction of MIFID II. The willingness of investors to buy research (and therefore the incentive for providers to produce it) can change in light of economic conditions, but once research coverage has ceased it is hard for it to restart.

Research payments rarely increase in good market conditions as they are seen by fund managers as largely a 'fixed cost', and largely centrally controlled at finance level rather than by the fund managers. Payment will be reduced in weaker market conditions and as such the provision of research inevitably deteriorates. Platform access fees were set at very low levels, enabling large fund managers to access research with low payments. Research is inherently unprofitable, evident both in the production of large-cap research, but particularly in research of small & mid-cap companies and therefore providers are not incentivised to maintain coverage of small & mid cap companies and often provide limited information on the companies that they do research.

The decline has been more marked in the EU and UK than other jurisdictions, especially versus the US.

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?**

Research provision is very important for the attractiveness of the UK but improving the provision alone will not be sufficient. Reform in research rules needs to be part of a broader suite of regulatory reforms. The UK equity market has been declining in importance both relatively and practically. This is manifest in the decline in the number of listed companies, lower valuations, the reduction in volume and quality of research, reduction in the level of trading, reduction in commissions and research payments, reduction in capital market activity and reduction in employment and tax revenues.

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?**

Sectors such as technology and life sciences have seen a greater drop in research provision as they tend to involve smaller companies and therefore it is harder to justify coverage given the regulatory focus on value for money.

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 above (Q4) and sub-FTSE-100

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?**

No comment

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.**

One area where unbundling rules have a had a noticeable impact is the interaction with US research markets, which forbid 'hard-dollar' payment for research unless the broker is a Registered Investment Adviser, which relatively few are. Following the expiration of the SEC's 'no action' letter for MiFID II regulated firms looking to pay for research "hard dollar" in the US, this will essentially make it impossible for UK investment managers to purchase research from many US providers, as to do so will mean they are in breach of either UK or US regulation.

We would therefore recommend that Government consider whether any changes or reforms would it make it more difficult for investment managers to acquire research in other regions and urge regulators to consider providing more flexibility under UK regulation for investment managers looking to pay for research from other regions if it is required for them to be in compliance with local regulations.

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)?**

The reforms although well intended do not appear to have had the desired effect. There are differing views amongst members on this topic, with some favouring a higher market capitalisation, to match the threshold being proposed in the EU, or to exempt certain high growth sectors of the market, whilst others are of the view that fund managers will not want to run dual systems, even with more substantial exemptions.

Amongst the reasons given, having two sets of rules does create administrative burden and, when compounded, with international divergence it does makes it hard for all parties to justify, on a cost-benefit basis, the effort of compliance. There is likely to also be complexity in managing the process if there was an arbitrary market cap/index cut-off, where companies move in/out of the MiFID II unbundling rules. Therefore, consideration on how to mitigate these concerns should be considered when developing policy proposals.

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?

No additional comments

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?

The principal of paying for time was established under the MiFID II rules, however this did not realistically reflect the level of research time involved nor the material difference in the skills provided. Analysts have a limited number of potential billable hours given the level of time required to maintain knowledge of their sector and companies. The reduction in payment for research, as previously outlined, has resulted in reduction in the size and level of seniority of/within analyst teams.

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?

See response to Q.3

International harmonisation on research provision regulation should be pursued as addressing the issues only in the UK will not be sufficient given research is a cross-border activity.

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**

We outline a number of potential steps below, in no particular order of priority.

The independence of research is an important principle that must be preserved. However, we should be open minded about the role sponsored research or academic-led research could play if appropriate safe-guards were in place. The benefits and challenges therefore of such research should be carefully considered as part of this review.

The initial intention behind MiFID II was that research payments should reflect the cost of providing that research. Unfortunately, this aspect was lost in the drive to reduce overall cost of research and as investors realised that they could minimise payments without losing access.

The FCA could monitor access payments for research to ensure this reflects the cost, rather than the current ad-hoc system whereby fund managers choose what to pay. Funds could be banded to ensure that smaller funds are not materially disadvantaged.

Consideration could be given to introducing a minimum commission rate for smaller companies (based on index inclusion).

Another option may be for corporates to be mandated as part of listing rules to ensure adequate research coverage. Corporate funded payments should be focused on making existing coverage economic rather than merely trying to encourage additional coverage.

We would be very happy to discuss our views with you further if this would be helpful.

Yours sincerely

The FCA's Markets Practitioner Panel
The FCA's Listing Authority Advisory Panel