

Consultation Paper **CP24/7*****

Payment Optionality for Investment Research

April 2024

How to respond

We are asking for comments on this Consultation Paper (CP) by **5 June 2024**.

You can send them to us using the form on our [website](#).

Or in writing to:

Wholesale Markets Sector Team
Financial Conduct Authority
12 Endeavour Square London
E20 1JN

Email:

cp24-7@fca.org.uk

When we make rules, we are required to publish an account of the representations we receive and how we have responded to them. We are also required to publish a list of the names of the respondents who made the representations, where those respondents have consented to the publication of their names. In your response, please indicate whether or not you consent to the publication of your name. For further information on confidentiality of responses, see the disclaimer at the end of this CP.

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Contents

	Foreword	3
1.	Summary	5
2.	The wider context	9
3.	Analysis	18
4.	Our proposals	46
Annex 1	Questions in this paper	58
Annex 2	Cost benefit analysis	60
Annex 3	Compatibility statement	75
Annex 4	Guardrail features in our survey	79
Annex 5	Abbreviations in this document	80
Appendix 1	Draft Handbook text	

Foreword



Nikhil Rathi
Chief Executive

High quality, easily available investment research supports deep capital markets, listed companies, and economic growth. That is why we are consulting on giving UK buy-side firms – asset managers and others – greater flexibility on how they can purchase such research.

We are proposing a new option, which allows the 'bundling' of payments for third-party research and execution services. This option would exist alongside those already available, such as payment from an asset manager's own resources, and payment from a dedicated research payment account.

In so doing, we have acted quickly in response to the Government-commissioned Independent Research Review, chaired by Rachel Kent.

Ahead of this consultation, we have engaged extensively with sell-side and buy-side firms, as well as research providers and representatives of end investors. We reviewed exhaustive written analysis and have conducted a detailed survey of buy-side firms to collect quantitative evidence. We thank all who have fed in to support our analysis.

Our survey tells us that investors are largely getting the research they need under the current rules. However, the current options available to UK asset managers are either operationally complex or may favour larger firms, impacting competition. The current regime can also impede UK asset managers' ability to purchase investment research produced outside the UK.

So, we are proposing a new regime, one that allows asset managers greater freedom to choose the way they pay for the analysis they rely on.

The changes we are putting forward seek to promote effective competition among asset managers by introducing a payment option that is operationally efficient and adaptable to firms of different business models and sizes. It is also compatible with rules governing payments for research in other jurisdictions, better allowing asset managers to buy research in the same way, across borders.

The rules preventing the bundling of payments were introduced in 2018 for good reason. There was a concern that the practice led to less disciplined spending on duplicative or low-quality research, inappropriate influence of research procurement considerations on trade allocation decisions, and opaque charging structures. Re-bundling of payments for research with trade execution charges could risk these harms re-emerging.

That is why we are suggesting appropriate guardrails to protect investors. These are designed to ensure sufficient discipline around budgets for research spending, fair allocation of costs to clients, value assessment, price benchmarking of research purchased, and cost transparency.

We hope to produce final rules, having considered carefully all the feedback we receive, in the first half of 2024, although that timetable inevitably is dictated by the amount, strength and breadth of feedback we receive as we consult.

The FCA is committed to taking steps to further strengthen the attractiveness of UK capital markets and to strengthen the UK's position in global wholesale markets.

Chapter 1

Summary

Why we are consulting

- 1.1** We are consulting on rules to introduce a new option to pay for investment research.
- 1.2** As part of the UK government's Edinburgh Reforms to drive growth and international competitiveness in UK financial services, the government requested an independent review of the investment research market. In July 2023, the independent panel chaired by Rachel Kent published its report – the Investment Research Review (IRR) – setting out a series of recommendations to improve the investment research market. This consultation paper (CP) arises from the FCA's consideration of recommendation 2 in the IRR, on creating an option for paying for research using a bundled payment for trade execution and research. This CP thereby delivers on our undertaking to consult on an accelerated timetable on potential regulatory changes that could introduce more options on how to pay for investment research. It also supports the FCA's strategic commitment to strengthen the UK's position in wholesale markets.
- 1.3** The IRR made a wider set of recommendations on research that the FCA could consider, including:
- Recommendation 3: allow greater access to investment research for retail investors.
 - Recommendation 6: clarify aspects of the UK regulatory regime for investment research and consider introducing a bespoke regime.
 - Recommendation 7: review the rules relating to investment research in the context of IPOs.
- 1.4** However, this CP focuses exclusively on recommendation 2, that we allow additional optionality when paying for investment research. Wider points were touched on in our discussions with industry, notably corporate access and fixed income research. We will consider those in due course once we turn to dealing with the wider recommendations of the IRR that are relevant to us.
- 1.5** UK rules currently prevent UK asset managers from purchasing research with bundled payments (whereby payments for execution and research are combined), other than when the payment is made from a Research Payment Account (RPA) – where the asset manager agrees a separate research charge with each of its clients. Most asset managers have not agreed separate research charges with clients but pay for research out of their own resources, such that research payments are a cost in the asset manager's overall profit and loss (P&L) statement. The current requirements stem from the Markets in Financial Instruments Directive, as revised in January 2018 (MiFID II).

1.6 In considering the recommendations of the IRR on payment for research, we concluded the following.

- The current option under which UK asset managers can charge investment research costs to clients (RPAs) is operationally complex and resource-intensive to maintain. It is primarily smaller firms that use this option, and such firms may be less able to use the alternative option, i.e. to pay for research from their own resources, with the current situation potentially creating barriers to new entrants or disadvantaging smaller firms and hence harming competition.
- Both of the currently available options can have negative effects on UK asset managers' ability to purchase investment research across multiple jurisdictions without significant and potentially disproportionate operational and regulatory complexities. This could impede their ability to compete effectively on a global basis.

1.7 These considerations largely underpin our proposals for adding a third option.

What we want to change

1.8 Our proposals aim to deal with the issues raised in the IRR and other issues that have been identified in discussions with market participants. In particular:

- We propose a new option that enables firms such as asset managers who wish to buy investment research to use joint (hereafter "bundled") payments for third-party research and execution services, provided that the firm meets the requirements in relation to the operation of these. This option will exist alongside those already available, i.e. payment for research from a firm's own resources (e.g. P&L) and payment for research from an RPA for specific clients.
- The requirements on firms in relation to this new option would include them establishing: a formal policy on use of the approach; a budget for the amount of third party research to be purchased; ongoing assessments of research value and price; an approach to the allocation of costs across their clients; a structure for the allocation of payments across research providers; operational procedures for the administration of accounts to purchase research; and disclosures to clients on the firm's approach to bundled payments, their most significant research providers, and costs incurred.

Question 1:

- a. Do you agree with our proposal to create additional payment optionality for investment research? [Yes, No, No view]**
- b. If yes or no, please explain your views.**

Question 2:

- a. Would you be likely to take advantage of the proposed new payment option? [Yes, No, No view]**
- b. If yes or no, please explain your views.**

Measuring success

- 1.9** Under the Financial Services and Markets Act (FSMA) 2023, we must keep rules in our Handbook under review. For more information on our rule review, please see our published [Rule Review Framework](#) on our website.
- 1.10** The success of the policy would be measured by take-up of the new option, which we can do via a firm survey or further multi-firm supervisory work. Such further supervisory work could also examine if there is any marginal increase in research production resulting from these changes and whether it is in sectors that benefit UK market functioning, competitiveness and growth (e.g. UK small and medium enterprises, or "SMEs"), or is from a sufficiently broad range of providers to indicate a competitive research market (e.g. smaller firms or independent research providers (IRPs)).
- 1.11** We have not, at this stage, determined in detail the key indicators we will use to monitor whether the new option being proposed in this CP is achieving the key outcome. We are planning to develop those key indicators in the coming weeks, as well as the data that we will be collecting to underpin the indicators. As indicated above, measuring success will require a collection of data which we can do via a survey. We will endeavour to do so in a proportionate way, so as to weigh the value of the data against any cost for firms in providing that data. It is likely that the benefits of the new option will manifest itself over the medium term and we may continue to monitor development in the investment research market over the next few years.
- 1.12** We will publish the key indicators and related data collection requirements as part of the policy statement when making our rules.

Question 3: **Do you have any views on key indicators that could act as success measures for the outcomes we are looking to achieve?**

Who this applies to

- 1.13** Our proposals are potentially relevant to:
- investment firms and market operators in the UK
 - asset managers
 - institutional investors such as pension schemes
 - insurance firms
 - banks providing investment services
 - persons providing research that we do not authorise
- 1.14** The policy intention is to make changes that ensure consistency across all the rules on research and inducements for investment firms and collective portfolio managers. To achieve this, we are aware that the proposed changes should also apply to fund managers, including UCITS managers and alternative investment fund managers, under Conduct of Business sourcebook (COBS) 18. We plan to set out the necessary

rule changes to achieve this alignment in a future consultation. The changes we are proposing to the list of minor non-monetary benefits in COBS 2.3A and the addition of payment optionality in COBS 2.3B are not at this stage mirrored in changes to the list of minor non-monetary benefits in COBS 18 Annex 1 relevant to:

- UCITS management companies
- full-scope UK Alternative Investment Fund Managers (AIFMs)
- small authorised UK AIFMs and residual Collective Investment Scheme operators

1.15 We will also consider how best to handle the timing of implementation of the respective rules.

1.16 Our consultation will also be of interest to individuals who use the services of the firms mentioned above as well as firms not authorised to provide investment services but that use the services of firms providing investment services, including pension funds and corporates. The proposals are also relevant to issuers whose shares are traded on public markets.

Next steps

1.17 We want to know what you think of our proposals in this paper. Please send your comments to us by 5 June 2024, using one of the methods in the "How to respond" section on page 2. Unless you have indicated that you wish your response to be confidential, we will not treat them as such. We are obliged to list the names of respondents, which is a matter separate from any request for the content of a response to be kept confidential. However, we will only publish the name of a respondent to a consultation where that respondent has consented to the publication of their name. We strongly encourage stakeholders to engage with us and respond as soon as possible, even in advance of these deadlines. This 8-week consultation period reflects both the accelerated timescale for consideration of this IRR recommendation we previously committed to, and the extensive industry engagement we have managed to undertake in the intervening period.

1.18 We will consider your feedback. If we choose to proceed, we would aim to publish any rules or guidance in a policy statement in the first half of 2024.

1.19 We also intend to consult on rule changes with respect to COBS 18 in the course of 2024 (see 1.14 above).

Chapter 2

The wider context

Legislative framework

MiFID II

- 2.1** The UK Markets in Financial Instruments Directive (UK MiFID) is the collection of laws that regulate the buying, selling and organised trading of financial instruments. The rules are derived from European Union (EU) legislation that took effect in November 2007 and were revised in January 2018 (MiFID II).
- 2.2** MiFID II introduced requirements to separate charges for execution from charges for research, thereby 'unbundling' these two services. Firms receiving research were required to either pay for research themselves from their own resources ("P&L" model) or agree a separate research charge with their clients (research payment account, or "RPA model"). The policy objectives of the MiFID II reforms were to manage conflicts of interest, improve accountability over costs passed to customers, and improve price transparency for both research and execution services. The MiFID II requirements were incorporated into the UK rules on inducements in COBS 2.3 and 18 (see 1.14 above).

CP 21/9

- 2.3** In [CP 21/9](#) and [PS 21/20](#), published in July and November 2021 respectively, the FCA consulted on and introduced changes to the rules relating to research. These changes aimed at ensuring the regulation of investment business in the UK was adapted to the broad and deep structures of UK markets, and underpinned by the highest regulatory standards that promote market integrity, effective competition and consumer protection.
- 2.4** These changes broadened the list of what are considered minor non-monetary benefits to include research on SMEs with a market cap below £200m and Fixed Income, Commodities and Credit (FICC) research, so that these are not subject to the inducement rules. They also made rule changes on how inducement rules apply to openly available research and research provided by IRPs. The CP also said we would remain open to considering the need for, and merit of, further measures to support SME research where robust evidence from stakeholders suggested that such clarification would help support the functioning of markets without distorting execution decisions.

Independent Research Review

- 2.5** The IRR was commissioned by HM Treasury to evaluate the provision of investment research in the UK and its contribution to the international competitiveness of the UK's capital markets, considering amongst other things the impact of the unbundling rules on payment for investment research on the supply and demand for

research services. The IRR's recommendations were published in July 2023. Considering reforms to how payments for investment research are made also forms part of the UK Government's Edinburgh Reforms to drive growth and competitiveness in the financial services sector, building on the Wholesale Markets Review (WMR) conducted in tandem with the Treasury following the onshoring of UK legislation.

- 2.6** The IRR concluded that the MIFID II unbundling requirements have had adverse impacts on the provision of investment research in the UK, and that this has a potentially negative impact on economic growth, as increased amounts of investment research could increase UK capital market depth thereby also increasing the amount of funding available to UK companies. The IRR also found that the existing unbundling requirements may reduce UK asset managers' access to global investment research, placing them at a competitive disadvantage against their international peers.

Arrangements in other jurisdictions

- 2.7** In the US, the use of "soft commissions" is commonplace, under which payments to broker-dealers for execution and research services are combined. The use of structures such as commission sharing arrangements (CSAs) is also prevalent; these allow asset managers to pay a broker-dealer for trade execution, yet to have the portion of commission allocated for research to be used to purchase it from a different broker-dealer or IRP. On the other hand, US broker dealers must register as investment advisers if they wish to accept payment for research separate from execution commissions. This is because separate payment can be treated as special compensation for the purpose of the Investment Advisers Act of 1940. The Investment Advisers Act of 1940 provides an exclusion from the requirement to register as an Investment Adviser if the investment advice provided by the broker-dealer is purely incidental to the brokerage business and they receive no "special compensation" for providing the advice.
- 2.8** In 2017, the Securities and Exchange Commission (SEC) issued a no action letter (NAL) providing relief to US broker-dealers accepting unbundled payments from EU and UK asset managers for research services. The relief expired in July 2023, and although evidence of any negative impacts on UK asset managers is limited, it is important for UK asset managers to be able to obtain research from global sources without impediments to remain globally competitive.
- 2.9** The EU is introducing legislative adjustments to the MiFID II unbundling rules to offer firms greater flexibility on how to pay for investment research services. This introduces a new payment option, alongside a number of requirements which an investment firm will have to comply with if they wish to bundle research payments with execution. The EU had previously also introduced targeted exemptions to its unbundling rules, some of which are similar to those introduced in the UK under CP 21/9 (see 2.3-2.4 above).
- 2.10** Our proposed option shares certain features in common with these recent EU legislative outcomes, e.g. transparency on the payment option selected by a firm, maintenance and disclosure to clients of a policy to manage conflicts of interest, regular assessments of the quality and value of research, an agreed methodology to separately identify

charges for research from trade execution, disclosure to clients of costs, and the exclusion of sales and trading commentary from relevant requirements. However, the EU changes do not set out expectations in certain other areas covered by our proposal, e.g. budgets for research spending, an approach to the allocation of costs across clients, and a structure for the allocation of payments across research providers. The EU will also introduce changes that have previously been introduced in the UK, such as the treatment of IRPs within the inducements regime (see 2.4 above).

Academic research on unbundling

2.11 The academic research on bundled payments for research and execution services often focuses on US markets, although the introduction of MiFID II has resulted in studies assessing its effect on markets in the EU and UK. These studies have different areas of focus when assessing impacts, ranging from market functioning (e.g. analyst coverage, bid/offer spreads) to investor outcomes (e.g. investment performance and costs under bundled and unbundled models). For this reason, relevant evidence and conclusions arising from them are covered under the appropriate sections of analysis of Chapter 3 below.

2.12 These studies, and how they are referenced hereafter, are:

- **Bender et al 2021** (To Bundle or Not to Bundle? A Review of Soft Commissions and Research Unbundling)
- **Fang et al 2020** (The Effects of MiFID II on Sell-Side Analysts, Buy-Side Analysts, and Firms)
- **Fu et al 2023** (Research Unbundling and Market Liquidity: Evidence from MiFID II)
- **Guo & Mota 2019** (Should Information be Sold Separately? Evidence from MiFID II)
- **Jackson & Zhang 2022** (The Law and Economics of Soft Dollars: A Review of the Literature and Evidence from MiFID II)
- **Jackson & Zhang 2023** ('Nobody is Proud of Soft Dollars': The Impact of MiFID II on U.S. Financial Markets)
- **Lang et al 2023** (MiFID II Unbundling and Sell Side Analyst Research)
- **Liu et al 2020** (Was MiFID II Effective In Unbundling Execution and Research Services)

2.13 Further detail, and how we have incorporated the findings of these in our analysis, is provided in Chapter 3.

Prior regulatory studies on unbundling

2.14 There have been prior regulatory studies undertaken on the impact of the MiFID II unbundling reforms on markets in the EU and UK. These studies frequently have similar areas of focus to the academic studies above, but in other cases expand their assessment to other areas (e.g. impacts on competition, impacts on choice and cost of provider in trade execution). For this reason, relevant evidence and conclusions are also covered under the appropriate sections of analysis of Chapter 3 below.

2.15 These studies, and how they are referenced hereafter, are:

- **FCA 2019** (Implementing MiFID II – multi-firm review of research unbundling reforms)
- **Oxera 2020** (Oxera Consulting for the European Commission, Final report on primary and secondary equity markets in the EU)
- **AMF 2020** (Reviving research in the wake of MiFID II: Observations, issues and recommendations)
- **ESMA 2020** (MiFID II research unbundling – first evidence)
- **ESMA 2021A** (MiFID II review report on the functioning of the regime for SME Growth Markets)
- **ESMA 2021B** (ESMA Working Paper No. 3 2021, MiFID II research unbundling: assessing the impact on SMEs)
- **AFME 2022** (AFME, Capital Markets Union, Key Performance Indicators, Fifth Edition, November 2022)

2.16 The EU-wide studies above include the UK in their analysis, being undertaken prior to, or immediately after, the UK's withdrawal from the EU.

2.17 Further detail, and how we have incorporated the findings of these in our analysis, is provided in Chapter 3.

Wholesale Markets Review

2.18 The Wholesale Markets Review was established to improve the UK's regulation of secondary markets, taking advantage of new flexibilities in financial services following our withdrawal from the EU. Our shared objectives with the Treasury for the WMR are to have a regime of capital markets regulation with the following characteristics.

- High standards. A regime characterised by robust standards that are effectively enforced, adhering to the highest international standards, and ensuring that market participants can operate in it with confidence and maintain trust in the operation of the market.
- Supporting economic growth. A regime that supports growth in the real economy, innovation, entrepreneurship and wealth creation across society, and facilitates investment, both in the short-term (by supporting the economic recovery from COVID-19) and sustainable long-term (as we transition to a low-carbon economy).
- Open and competitive markets. A regime that allows a range of participants (domestic, international, public/private sector organisations) to access UK markets easily, appropriately and at a low cost, with high levels of competition and innovation, cementing the UK's position as a global hub for wholesale markets business.
- Fair and proportionate. A regime that is underpinned by proportionate standards that are focused on outcomes rather than prescriptive rules and strong infrastructures that enable market participants to operate in the market without unnecessary friction and costs.

How it links to our objectives

Competition

- 2.19** The changes proposed should advance our competition objective by promoting effective competition for asset management services among asset managers and improving the ease with which new entrants can enter this market. This would in turn mean that investors are able to benefit from greater competition amongst asset managers. Our intervention may also have competition benefits for new entrants and incumbents in the market for research.
- 2.20** Our evidence indicates that where RPAs are used, it is primarily smaller firms that use them, as they have less ability to absorb research costs into their own resources. In our engagement, firms highlighted that it can be operationally complex and resource-intensive to use RPAs. As such complexities and resource demands have a proportionately larger effect on smaller firms, this can put them at a competitive disadvantage. In our survey, only a small number of firms use RPAs to pay for research, all of which were smaller firms. We also found that these firms were more interested in using the new payment option when compared with firms that do not currently use RPAs. If such firms use the new option, it should be less operationally burdensome and less resource-intensive to them, and they would therefore be able to better compete. This would not necessarily result in additional costs to be borne by clients, as with RPAs such costs are already borne by clients. Furthermore, the guardrails we have proposed for the new option (especially those with respect to budgeting) should maintain discipline on the costs borne by clients, albeit with greater flexibility in implementation of controls than existing RPA requirements.
- 2.21** Bundled payments may also be more adaptable to the business models of new entrants and small but fast-growing firms, i.e. they should enable an asset manager to grow without being disproportionately constrained by available resources, as funds for the purchase of research would grow in line with overall business growth. They consequently do not have the barriers of high fixed costs that would be needed to build internal research capabilities, to pay for research from own resources (while facing commercial challenges in absorbing these), or to establish more operationally demanding RPAs (including the outlays required to build and maintain these).

Question 4:

- a. 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, No, No view]**
- b. If yes or no, please explain your views.**
- 2.22** Finally, submissions of evidence for this consultation indicated that reduced research spend has led to downward pricing pressure on research, that there is a smaller number of research providers, and that more research expenditure is going to the top providers of research (and hence there is increased concentration in the research market). Aside

from these submissions of evidence, there were qualitative assertions of potential cross-subsidisation of research activities by existing providers, and of little space for new entrants or for innovation, due to a hesitancy by firms to onboard new research providers (supposed to have arisen from increased procedural frictions under MiFID II requirements). The intervention we propose as part of this CP may be beneficial in addressing such competition considerations.

Consumer protection

- 2.23** One of our operational objectives is to secure an appropriate degree of protection for consumers. We believe the changes proposed should advance our competition objective, but without undue costs or harms to consumers. We are proposing guardrails around firms' use of the proposed option. These are intended to ensure sufficient discipline around budgets for research spending, fair allocation of costs to clients, value assessment, price benchmarking of research purchased, and transparency of costs incurred to clients.
- 2.24** It is also our expectation that use of the new option might, at least initially, be more prevalent among firms that currently use RPAs (see 2.20 above). In such cases, it will have a more limited impact on costs borne by investors, as under both payment options clients incur research costs, and the guardrails proposed should mitigate any other risks as asset managers migrate from one payment option to another. More widespread uptake of the new option could prevail, however, including by firms that currently pay for research from their own resources. We intend that the proposed features of the new option would still have sufficient levels of discipline and transparency in such circumstances, and would be interested in respondents' views on this also.

Question 5:

- a. Do the guardrails we are proposing around firms' use of the proposed payment option secure an appropriate degree of protection for consumers? [Yes, No, No view]**
- b. If yes or no, please explain your views.**

Market integrity

- 2.25** The changes proposed may also advance our market integrity objective, though the benefits in this case are less certain. There is little evidence that the current regulatory regime on research might be a significant cause of harms to the functioning of UK equity markets. Perceived harms either pre-date MiFID II, or cannot be attributed directly and solely to the regulatory changes introduced by MiFID II. Nonetheless, the changes could lead to an increase in the amount and breadth of research purchased by UK asset managers, which will improve information availability to them. Increased information availability should have either a neutral or positive benefit on UK equity market functioning; its impact is unlikely to be negative. However, we conclude that the benefits arising from this are most likely to be indirect and to asset managers (e.g. enhanced understanding of new sectors, business models and product innovations), and less likely to be direct and with respect to overall UK equity market functioning (e.g.

analyst coverage, liquidity levels). Overall, we conclude that the impact of the changes proposed on market integrity should be neutral or marginally positive, but with a lesser evidence base.

Secondary International Competitiveness and Growth objective

- 2.26** FSMA 2023 implements the outcomes of the Treasury's Future Regulatory Framework (FRF) Review and makes important updates to the UK's framework for financial services to reflect the UK's new position outside of the EU. FSMA 2023 also introduces a new secondary international competitiveness and growth objective for the FCA. The need to comply with the objective was reflected in the remit letter, of 9 December 2022, to which we must have regard.
- 2.27** When advancing our primary objectives of consumer protection, market integrity and effective competition in the interest of consumers, we have a secondary objective to facilitate the international competitiveness of the UK economy, and its medium to long-term growth, subject to aligning with relevant international standards.
- 2.28** When considering the design of the new payment option we have had regard to the payment structures allowed by other jurisdictions (e.g. CSAs). We have aimed where possible to align features of the new payment option to those in other jurisdictions. As a result, the proposed new payment option should facilitate asset managers accessing research globally, which could mean that UK asset managers are better able to compete on an international scale.

Question 6:

- a. 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? [Yes, No, No view]**
- b. If yes or no, please explain your views.**

Wider effects of this consultation

- 2.29** Annex 2 sets out our analysis of benefits and costs to firms and consumers from our proposals.
- 2.30** We have kept the statutory Listing Authority Advisory Panel (LAAP) and Market Practitioners Panel (MPP) updated on a regular basis. The panels have been supportive of our proposal to introduce additional payment optionality for investment research. Both panels offered the views that effectiveness of changes might be contingent on external factors which stem from outside of the regulatory landscape, e.g. growth in investment in UK equities, which would increase demand for research. It was agreed that global alignment in regulation would be a likely factor in encouraging uptake of the flexibility offered by payment optionality.

Unintended consequences of our intervention

- 2.31** There is a risk that, in spite of the guardrails accompanying the new option, it reintroduces the opaque charging structures, overconsumption of research, and conflicts of interest that were prevalent before MiFID II. Further guidance and more prescriptive standards could follow, if the FCA determines that firms have not implemented the new option in a satisfactory way.

The Consumer Duty

- 2.32** The Consumer Duty (the Duty) applies across retail financial services and came into force for open products and services on 31 July 2023. It comes into force for closed products on 31 July 2024.
- 2.33** The Duty sets higher and clearer standards of consumer protection and is at the heart of the FCA's shift to outcomes-based regulation. It requires firms to focus on acting to deliver good customer outcomes. Firms must act in good faith towards customers, avoid causing foreseeable harm to customers, and enable and support customers to pursue their financial objectives. Under the Duty, we expect firms to be able to identify, monitor, evidence through data, and stand behind the outcomes their customers experience. The Duty also sets requirements for firms in key areas including product and service governance and distribution, price and value, communications, and support. More information is available [here](#). Where the obligations of the Consumer Duty apply in relation to a firm's business, products or services, the firm should ensure its policies and operational arrangements for bundled payments for third-party research and execution services provide an appropriate level of protection for retail customers, in accordance with the requirements of PRIN 12 and PRIN 2A. The relevant Consumer Duty considerations with regards to bundled payments for research and execution would include the price, value of, and communications which consumers receive about research. Even in the absence of deliberate exploitation, consumers' ability to make good decisions can be impaired by various factors including weaker bargaining position, asymmetries of information, lack of understanding or behavioural biases.

Environmental, social & governance considerations

- 2.34** In developing this Consultation Paper, we have considered the environmental, social and governance (ESG) implications of our proposals and our duty under ss. 1B(5) and 3B(c) of FSMA to have regard to contributing towards the Secretary of State achieving compliance with the net-zero emissions target under section 1 of the Climate Change Act 2008 and environmental targets under s. 5 of the Environment Act 2021. Overall, we do not consider that the proposals are relevant to contributing to those targets. We will keep this issue under review during the consultation period and when considering whether to make the final rules.
- 2.35** In the meantime, we welcome your input to this consultation on this.

Equality and diversity considerations

- 2.36** We have considered the equality and diversity issues that may arise from the proposals in this Consultation Paper.
- 2.37** Overall, we do not consider that the proposals materially impact any of the groups with protected characteristics under the Equality Act 2010 (in Northern Ireland, the Equality Act is not enacted but other antidiscrimination legislation applies). But we will continue to consider the equality and diversity implications of the proposals during the consultation period and will revisit them when making the final rules.
- 2.38** In the meantime, we welcome your input to this consultation on this.

Chapter 3

Analysis

Introduction

- 3.1** In this chapter we set out background information on how research is paid for and provide analysis of the various considerations that could inform the development of a new payment option.

How investment research is paid for

- 3.2** Investment research provides a crucial role in providing information to potential and existing investors. It allows them to understand a publicly traded company and assess the risks connected with the investment. Historically, brokerage firms typically 'bundled' research costs with execution commissions (i.e. the cost charged to clients to trade in shares).
- 3.3** MiFID II introduced requirements to separate charges for execution and charges for research, thereby 'unbundling' these two services. Firms receiving research were required to either pay for research themselves from their own resources (P&L model) or agree a separate research charge with their clients (RPA model).

Independent research review

- 3.4** The IRR reiterated that investment research is an important component of an effective and attractive public capital market, and that the availability and quality of expert analyst research in the UK is significant in attracting and retaining issuers and investors to UK capital markets. It said that increased amounts of higher-quality research can create a virtuous circle, leading to improved valuations for listed companies, enhancing information to investors to inform decisions, and fostering greater liquidity in UK equity markets. While stating that the provision of investment research in the UK is comparable with other international financial services centres, it raised the following concerns.
- That while larger cap companies (with a market capitalisation above £1 billion) are generally well served in terms of analyst coverage, smaller cap companies are not.
 - That while UK investment research is not regarded as deficient in specific market sectors, because there is a smaller number of listed companies in certain sectors (such as technology), there will consequently be fewer analysts specialising in such sectors, as research is responsive to the number and size of companies listed.
 - That there is a perceived "juniorisation" of sell-side investment research, with research undertaken by less experienced staff, with more companies to cover, and that this may have consequences for the quality of research being produced.

3.5 The IRR consequently identified seven areas for action to develop investment research in the UK. The second of these was allowing additional optionality for paying for investment research, the recommendation on which this consultation is focused.

3.6 In respect to this recommendation, below is a summary of what the IRR said.

- **That the MiFID II unbundling requirements have had some adverse impacts on the provision of investment research.** Firstly, that the decision of many asset managers to pay for external research from their own resources (attributed to the complexity of using RPAs), while simultaneously increasing their internal research capabilities, has reduced both the quality and broader availability of research. Second, that there are arguments that this reduced spend on investment research may have had a detrimental effect on investment returns. Third, that paying for investment research from own resources may be less sustainable, as it is susceptible to spending cuts during a market downturn (when fee income on assets under management declines), is less responsive to changes in demand (e.g. meeting ESG requirements or reallocating capital to domestic small cap companies), and is less likely to foster speculative and innovative research (e.g. in niche and growth sectors). It relayed views that the bundled payment model in other jurisdictions (e.g. the US) can enable investment banks and brokers to invest more in developing research capabilities and maintain broader coverage. However, the IRR acknowledges other contributory factors, such as the reduction in UK equity allocations by domestic institutional investors (such as pension schemes), and that certain developments pre-date the MiFID II unbundling rules.
- **That not all the anticipated benefits of MiFID II unbundling requirements have been achieved.** First, that it has not necessarily led to more transparent pricing of research, even when unbundled from trade execution. Second, that it has not led to greater availability of research from different sources, for instance increased regulatory requirements for research procurement may have led some asset managers to limit the number of providers they purchase from. However, the IRR acknowledges that the principles underpinning the MiFID II reforms are generally not disputed, and that it has had some positive effects (e.g. reducing the amount of relatively unsophisticated and duplicative research).
- **That UK asset managers should be able to procure investment research on an international basis, but that the MiFID II requirements prevent them from purchasing from jurisdictions that still operate to a bundled model.** It stated that the MiFID II requirements may consequently create impediments to UK asset managers operating internationally (placing them at a competitive disadvantage), and could impact investment performance by restricting the information they can access. It noted the expiry of the no-action letter of the US SEC, which had previously permitted US broker-dealers to receive payments on an unbundled basis from asset managers that are subject to the MiFID II requirements.

Analysis

3.7 In the following sections we consider the introduction of a new payment option from the following perspectives:

- Market functioning
- Capital access and costs
- Investment performance
- Investor costs
- Competition
- Competitiveness and growth

Market functioning

- 3.8** Investment research can increase the information availability on issuers, thereby improving the efficiency of capital markets. These information benefits could foster more accurate valuations in primary markets and enhance liquidity in secondary markets. This could in turn have an overall positive effect on the FCA's objective of ensuring that markets are functioning well. For this reason, we examine the potential effect of MiFID II on the coverage of UK listed companies by research analysts, the quantity and quality of investment research available, and any relationship between these and indicators of liquidity (e.g. trading volumes or bid/offer spreads).

Prior FCA reviews

- 3.9** In FCA 2019, we found no evidence of a material reduction in research coverage, including for listed SMEs. Corporate issuers also saw little change in research coverage, but expressed concerns that research coverage or quality could deteriorate over time. FCA analysis concluded there had been limited change in single-stock analyst coverage levels for smaller-cap listed UK companies since MiFID II was implemented, and that trading volumes or spreads for AIM-listed companies did not appear to be affected.
- 3.10** In CP 21/9, we again found that MiFID II had not significantly affected research analyst coverage, including for smaller UK listed companies. However, we noted that the coverage level was low, and a significant proportion of companies at the lower end of the market cap spectrum were without any coverage. In terms of liquidity, it noted that bid-offer spreads had not widened significantly since MiFID II, but there was some increase for very small cap firms, and hypothesised that there may be other factors at play (e.g. a low volume of transactions makes it harder to support the cost of a sell-side research analyst). To address this, PS 21/20 broadened the list of "minor non-monetary benefits" to include research on SMEs with a market cap below £200m, so that they would not be subject to the inducement rules (see 2.3-2.4 above).

Other regulatory reviews

- 3.11** ESMA 2020 found that the introduction of MiFID II had not led to a significant change in analyst coverage, that increases in the number of companies not covered appeared to be a continuation of a long-term trend, and that SMEs did not appear to be disproportionately affected. Oxera 2020 noted that unbundling might have had an externality of reduced research coverage of, and liquidity in, SMEs. ESMA 2021B found that the quantity of SME research, the quality of SME research, and the probability of an SME completely losing coverage, had not worsened relative to larger firms since the

introduction of MiFID II. However, it did find that SME liquidity conditions measured by bid ask spreads had worsened relative to larger firms, but not the depth (illiquidity and turnover metrics). Overall, it concluded that there were challenges facing SMEs, but the situation had neither been improved nor worsened by the MiFID II unbundling provisions. AFME 2022 found declines in median analyst coverage in the EU (especially for SMEs), but found that this pre-dated MiFID II (though it accelerated around the introduction of MiFID II), while in the UK it observed no change either in large or or small cap coverage.

Academic studies

- 3.12** There have been general studies on the link between analyst coverage and market liquidity. For instance, Roulstone 2004 (*Analyst Following and Market Liquidity*) found that a 10% increase in the number of analysts resulted in a 4% decrease in the bid/ask spread.
- 3.13** There have also been numerous academic studies of the impacts of MiFID II specifically. Their conclusions vary. A set of studies with some commonality in findings are Jackson & Zhang 2022, Jackson & Zhang 2023, Guo & Mota, and Fang et al. These found that:
- MiFID II resulted in decreases in analyst coverage, albeit usually in large cap not small cap firms, assumed by authors to be due to the elimination of overproduction of duplicative research.
 - There were better quality forecasts by analysts, assumed by authors to be due to the departure of less accurate analysts whose research market participants were now unwilling to pay for.
 - There was more direct engagement with listed companies by buy-side analysts, assumed by authors to be due to the expansion of internal capabilities to offset reduced procurement of sell-side research.
 - There was mixed evidence of equity market liquidity decreases. For instance, Jackson & Zhang 2023 found no evidence of liquidity decreases on UK markets, while Fu et al found significant drops in analyst coverage and deteriorating market liquidity on the London Stock Exchange.
- 3.14** Finally, Jackson & Zhang 2022 and 2023 consider the argument that bundled payments provide a public good by subsidising a socially optimal level of research production that consumers would not otherwise pay for and thereby support market functioning. However, they conclude that the argument is not robust, and had previously been used to counter the elimination of anti-competitive practices (e.g. fixed commission rates on equity transactions). They also conclude that there is no evidence that increased research expenditure under bundled commissions actually promotes new research, rather than generating marginal research in areas already adequately covered or increasing the compensation of existing research analysts in such areas.
- 3.15** The overall balance of evidence is not conclusive, but suggests that the impacts of unbundling have been largely positive, and where there might be negative impacts (e.g. reduced liquidity) it is challenging to isolate these from other causes (e.g. the challenging economics of maintaining research coverage to support low trading volumes in small caps).

Further analysis undertaken for this consultation

- 3.16** In our industry engagement, we organised a series of roundtables with a wide range of firms, and received submissions of information from such firms and other market participants also. We especially sought quantitative evidence on changes in the amount and quality of research and its impacts on market functioning. We initially received limited quantitative evidence, however, with much of it qualitative or of limited scope. Many participants asserted that it is difficult to measure research quantity and quality (viewing it as a service, rather than a set of transactions). One submission provided data demonstrating a circa 20% reduction in sell-side analyst headcount in the UK from MiFID II through 2023 (albeit with a concurrent, but more gradual, reduction in a major non-MiFID jurisdiction), and a reduction in metrics of UK sell-side analyst experience/tenure over the same period (albeit to a lesser extent than other jurisdictions, including a major non-MiFID jurisdiction). The latter trend had already begun to reverse itself in 2023.
- 3.17** Notwithstanding the challenges of collating quantitative evidence, a number of market participants did support strongly the overall view put forward by the IRR, i.e. that the MiFID II unbundling requirements have had adverse impacts on the provision of investment research in the UK, and have reduced both the availability and quality of research on UK listed firms (see 3.6).
- 3.18** On the other hand, other market participants asserted that they are receiving sufficient research that meets their needs, that quality has not reduced, that oversupply has been eliminated, and that reduced research budgets simply represent more efficient expenditure (and not decreased consumption). Those market participants noted the importance of other factors that may explain low research availability, including the following.
- The **small investable universe of UK SMEs**, creating challenges for a viable economic model for providing SME research coverage, and reducing the level of focus in an increasingly globalised asset management industry. For instance, as of November 2023, there were £9.5bn of assets in the Investment Association (IA) UK Smaller Companies category, compared to £136.9bn in its UK All Companies category, according to its [sector statistics](#).
 - **The declining allocations to UK equities** by both institutional and retail investors in the UK, which was considered the single most important factor by many market participants. For instance, according to Peel Hunt's report [Problems in plain sight](#), pensions funds have declined from constituting circa 32% of UK equity ownership in the early 1990s to circa 2% today, while for insurance companies this decline is from circa 24% to circa 3%.
 - The **growth of passive investing**, which often has lesser or different research requirements. According to the IA [annual survey](#) of investment management in the UK, passively managed funds were 33% of assets under management in 2022, up from 20% in 2012. Although this percentage is not specific to UK equities, and does not reflect overseas investors in UK equities, it is indicative of a relevant broader trend.
 - The **growth of private markets**, as companies that are privately held would not generate such broad research demand as publicly listed companies. For instance, according to [LSE data](#), the number of LSE listed issuers fell from 2,365 to 1,836

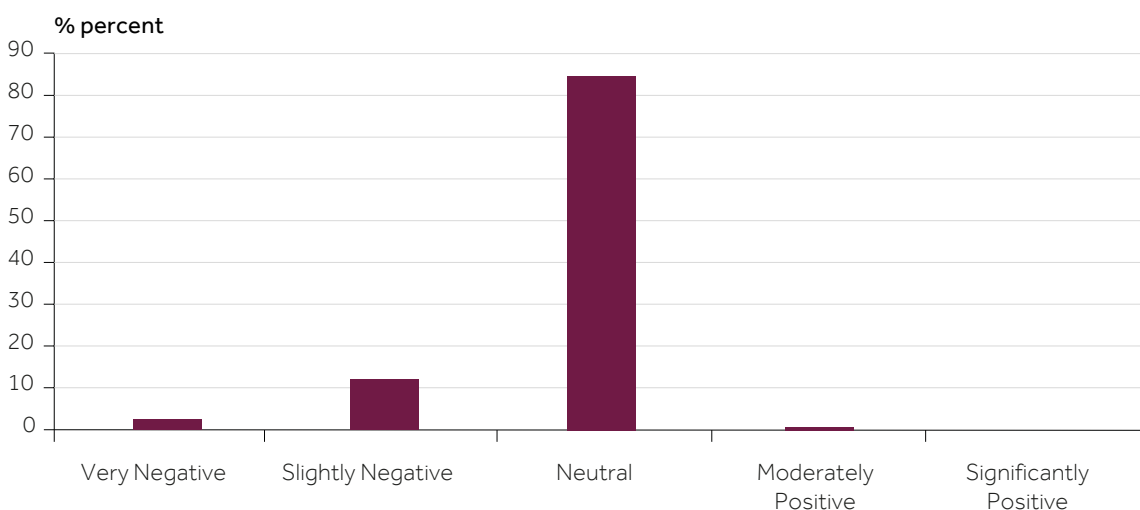
between 2015 and 2023, whereas, according to [PitchBook UK Private Capital Breakdown 2023](#), private equity transactions rose from 1,088 to 1,863 between 2015 and 2022 (estimated deal count), and for H1 2023 were 1,106 (estimated deal count).

- **Industry consolidation among asset managers**, reducing total research spend.
- **Industry consolidation among research providers**, reducing research output.

3.19 For these reasons, some believed that any link of low research availability to unbundling rules are coincidental and not causal, and thus other measures are more appropriate to address any issues.

3.20 To inform this consultation, we also undertook a survey of asset managers in February 2024 (see Annex 2 for further detail), the outcomes of which are covered here and in the sections that follow. In this, we sought to examine asset managers' views on the adequacy of research available specifically on UK issuers. A large majority of asset managers responded that MiFID II has had a neutral impact on the adequacy of coverage of investment research on UK equity issuers.

Figure 1: What impact do you consider MiFID II has on the adequacy of coverage (combining quantity and quality) of investment research specifically on UK equity issuers?

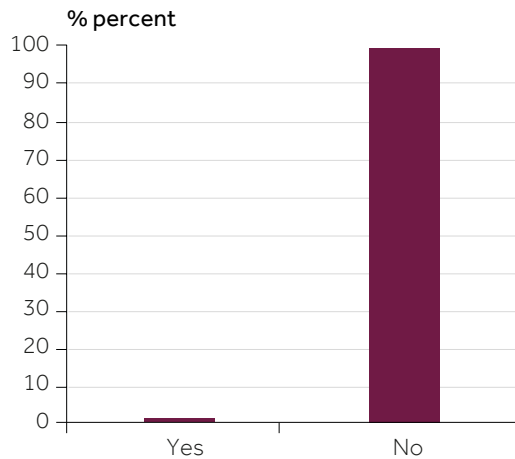


3.21 In our industry survey, we also collected data on research spend for UK small cap equity research. (We examine broader trends on overall research spend under 3.40-3.62 below.) However, the challenges of firms providing such data (especially in a standardised or comparable form) precluded us from drawing any conclusions.

3.22 In our industry survey, we also sought to examine whether the changes introduced as part of PS 21/20, as outlined under 2.3-2.4, had improved information availability on UK SMEs. As these changes disapplied the inducement rules for certain UK SME issuers, any uptake might indicate that research supply and demand for SMEs is indeed responsive to changes in unbundling rules. However, we found that very few firms in our survey sample had used this new ability to pay for research on SMEs on a bundled basis. To explain this, industry engagement suggested that small-scale adjustments to procurement rules

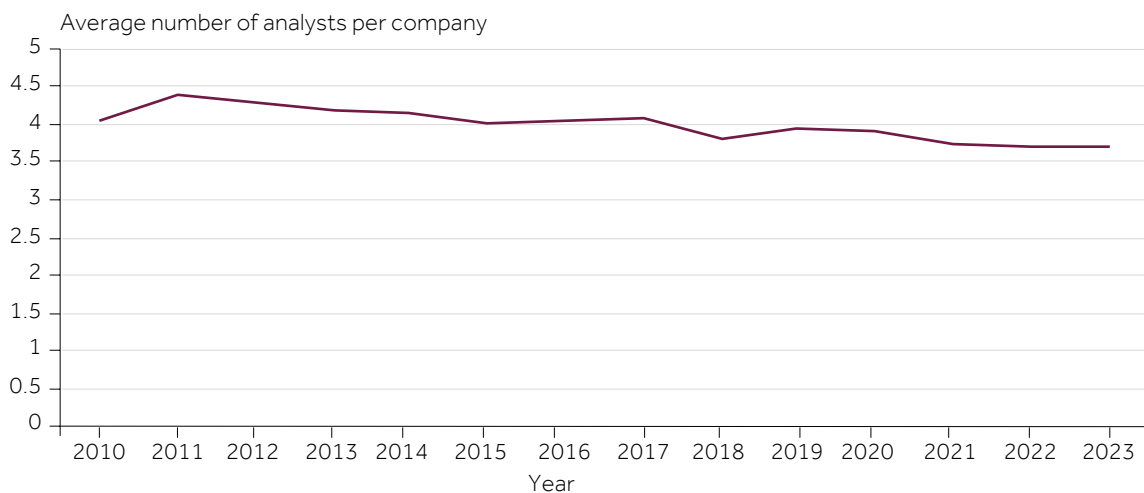
that necessitate new operational workflows for small cohorts of issuers are not effective interventions, a view we take into account when framing the option proposed in this paper in Chapter 4.

Figure 2: Is your firm currently paying on a bundled basis with trade execution for research on equity issuers with a market capitalisation below £200m, in line with the adjustments to the MiFID II regime introduced under CP 21/9



3.23 Finally, our own analysis found that, whilst analyst coverage for UK companies has been decreasing over recent years, this decline has been relatively moderate and some of the decline pre-dated the research and unbundling requirements of MiFID II. Figure 3 shows that analyst coverage of UK companies peaked in 2011 at approximately 4.4 analysts per company before declining to 4.1 analysts in 2017 (two months before MiFID II came into force) and declining further to 3.7 analysts in 2023.

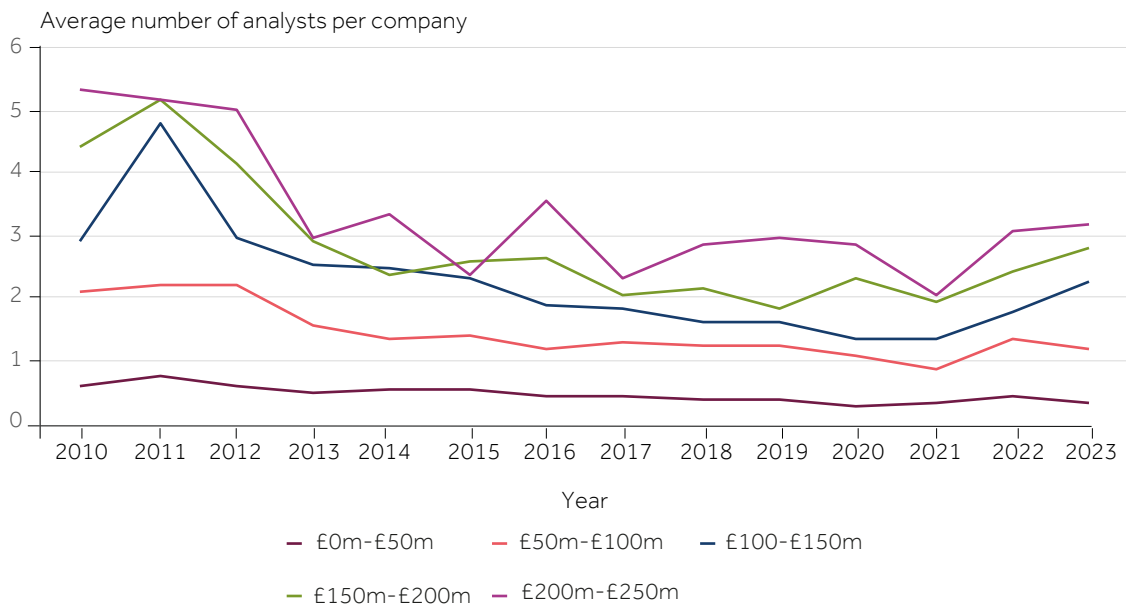
Figure 3: Average number of research analysts covering UK public companies



Source: FCA, Bloomberg. All dates correspond to November of that year

3.24 We also examined how analyst coverage has changed over time for UK SMEs. Figure 4 shows that coverage for public companies with market caps of below £250m has decreased significantly since 2010. Much of this decrease in coverage occurred pre-MiFID II (i.e. from 2010-2014). Since MiFID II came into force, it is only firms with a market cap of between £0m and £100m that have seen flat or decreasing coverage. The larger SMEs with market caps of between £100m and £250m have started to see an increase in coverage in the last few years.

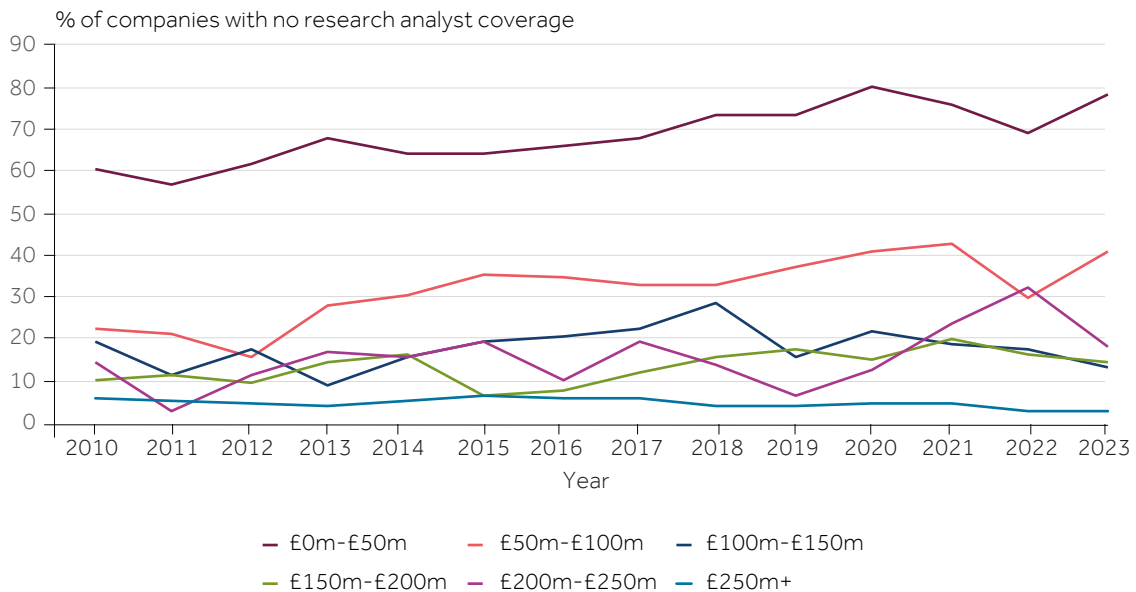
Figure 4: Average number of research analysts covering UK public companies with a market cap of less than £250m



Source: FCA, Bloomberg. All dates correspond to November of that year

3.25 We note that whilst the figures provided above are useful, the averages may mask trends in the proportion of companies that do not have any analyst coverage at all. This is an important metric as it is these companies which would benefit the most from increased coverage. Figure 5 shows that it is the smallest companies that have lost analyst coverage over the period studied. For example, the proportion of companies with no analyst coverage in the £0m-£50m and £50m-£100m brackets has increased from 61% to 78% and 23% to 41% respectively. However, this trend also seems to pre-date MiFID II.

Figure 5: Percentage of companies with no research analyst coverage, by market cap



Source: FCA, Bloomberg. All dates correspond to November of that year

- 3.26** We also looked at analyst coverage for specific sectors, which is covered under international competitiveness and growth (see 3.86-3.88 below).
- 3.27** In interpreting these trends, we remain cognisant of market participants views that analyst coverage numbers may not necessarily take into account changes in breadth/depth of coverage (e.g. one analyst covering an increasing number of companies), decreased specialisation (e.g. one analyst covering a broader range of sectors), and changes in seniority/experience levels (as covered in 3.4 and 3.16 above). We sought to quantify some of these changes also, but it was challenging to reach robust conclusions with the data available.
- 3.28** It is also important to note that our proposed intervention may not have a significant impact on UK equity markets because of the significant allocation of UK investors to non-UK equities (see 3.18), meaning that additional research is more likely to be consumed on overseas issuers.
- 3.29** In summary, there is very limited quantitative evidence to suggest that the current regulatory regime has been significantly detrimental to the functioning of UK equity markets. In part this reflects the fact that any changes observed in the data available either pre-date MiFID II or cannot be attributed directly and solely to the regulatory changes introduced by MiFID II. However, there may be indirect benefits that arise from increased information availability in the investment process of asset managers; these are covered in 3.34-3.39.

Capital access and costs

- 3.30** Increased information about a security enhances the ability for markets to accurately value it, as it reduces the information asymmetry facing investors. Consequently, increased levels of research could lower primary issuance costs. Lower costs of finance can have a positive effect on the amount of investment in the real economy.

- 3.31** In CP 21/9, the FCA took into account the findings from academic research on the general relationship between research coverage and the cost of primary issuance. For instance, Bowen et al 2003 ([Analyst Coverage and the Cost of Raising Equity Capital: Evidence from Underpricing of Seasoned Equity Offerings](#)) found that firms with the median level of analyst coverage (in their sample, three analysts) had a 1.19% lower seasoned equity offering underpricing, compared to firms without coverage.
- 3.32** In preparing this consultation, we sought quantitative evidence on the causal chain between analyst coverage and issuers' capital costs and valuations. We did not receive any submissions. However, some market participants relayed qualitative views that low quantity and quality of research coverage could result in UK companies trading below fair value, especially in high growth sectors that are not well understood by prospective investors.
- 3.33** Consequently, our analysis concluded that the causal link between research availability and capital access/costs is plausible, but not empirically evidenced in the context of the potential changes examined in this consultation. This aligns with the findings of Bender et al that the impact of unbundling on companies' access to financing is a specific area that leaves further room for research.

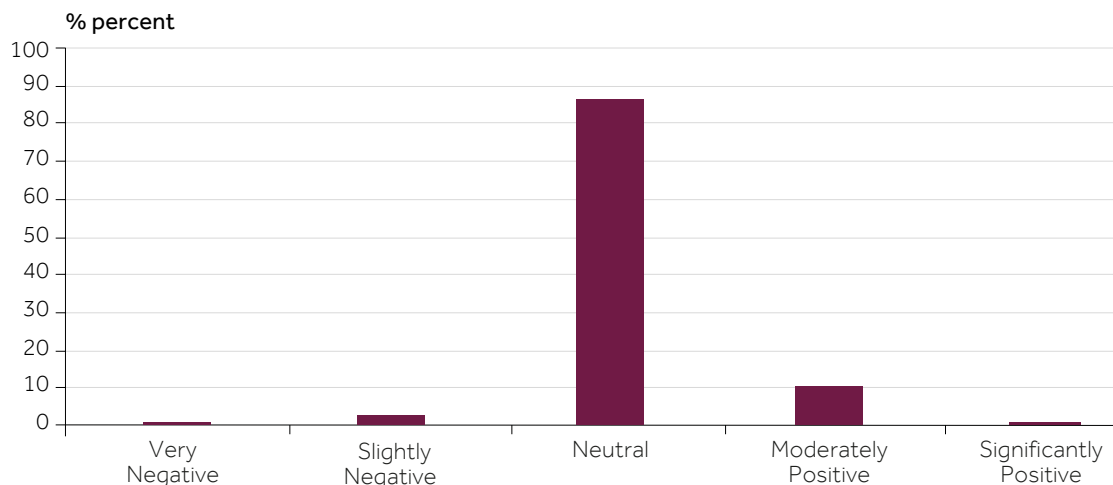
Investment performance

- 3.34** In CP 21/9, we noted that more information and better asset allocation decisions due to better access to investment research could lead to higher and less risky returns for investors. This would especially be the case if the additional costs of research (covered in 3.40-3.62 below) were outweighed by the incremental investment returns generated by such research.
- 3.35** Academic studies on the topic often cover other markets, which means the scope of what is considered "investment research" (and hence procured via bundled payments) can differ from that of the UK. Such studies are also challenged by the absence of comprehensive datasets to link research payments with investment performance. While there could be a theoretical argument that increased research might improve investment performance, such studies have mixed outcomes and struggle to evidence causal links. For instance, Jackson & Zhang 2023 conclude that there is no empirical evidence that links increased levels of bundled research payments with improved risk-adjusted investment performance consistently over long horizons. They also question whether in some cases improved returns are from "tainted alpha" that accompanies such bundled payments (e.g. preferential treatment in IPO allocations or corporate access), rather than from the research itself. However, they also acknowledge a subset of studies that have identified the underperformance of European funds compared to US counterparts since the introduction of MiFID II, albeit with the same challenges in measurement period outlined above.
- 3.36** In preparation for this consultation, market participants did not generally emphasise improved investment returns from increased research consumption as grounds to amend the existing rules, with some respondents asserting that declines in the amount of research purchased had not necessarily led to worse outcomes for end-investors. Submission of more structured or quantitative information in this respect

was very modest, with some respondents echoing the challenges of attributing investment outperformance specifically to research consumption, and emphasising its general importance in the investment process over specific metrics of contribution to investment returns. Data received seeking to demonstrate such a link only covered very short, and often fluctuating, time horizons.

3.37 As part of our firm survey, we sought views from asset managers on the extent to which the MiFID II reforms had impacted that outcomes that they can achieve for investors. We found that a large majority believed it had no impact.

Figure 6: What do you consider has been the impact of MiFID II on your firm’s investment process and the investment outcomes you have been able to achieve for your customers?



3.38 This does not mean that increased optionality for how to pay for research, which in turn improves the availability of investment research, might not benefit the investment process, and potentially even investment returns, in other ways. These include:

- Improved risk management and due diligence capabilities, and an enhanced ability to understand nascent market sectors and innovative company business models, or at least reduced search costs in undertaking such activities. Taken at the extreme, if investment research availability is sufficiently sparse in specific market segments, then the basic confidence to invest could be impeded.
- Increased investment research availability for the UK equity market could make it more internationally competitive, attract increased investment inflows, and thereby improve the market-wide valuation of UK listed equities. This could thereby increase investment returns for investors in UK equities in general terms, as opposed to increasing the relative performance of specific investors that consume such research.

3.39 Overall, we conclude that the causal link between research availability and investment performance is plausible, but not empirically evidenced in the context of the potential changes examined in this consultation. However, we remain cognisant of the broader benefits of research within the investment process (beyond its specific contribution to performance) and for the international competitiveness of an equity market as a whole (which may positively impact market-wide performance).

Investor costs

3.40 This section looks at the potential impact of bundled and unbundled payments on investor costs. Introducing a new option could potentially result in additional research costs being borne by investors, where the benefits could accrue either to asset managers (reduced research costs) or research providers (increased revenues). This could especially be the case where regulated firms have until now absorbed research costs into P&L, rather than charging them to clients via RPAs. There is also a risk that some previous harms re-emerge, such as less disciplined spending on duplicative or low-quality research, inappropriate influence of research procurement considerations on trade allocation decisions, and opaque charging structures.

Outcome of prior reviews

3.41 In FCA 2019, we found that unbundling had improved accountability and transparency over both research and execution costs, and reduced costs borne by investors. Since the introduction of unbundling, research budgets set by firms had reduced by 20-30%, with estimated annualised recurring cost savings of around £140m for investors in UK-managed equity portfolios. It also found that separating research costs had enabled asset managers to assess their use of high-cost vs low-cost trade execution channels, resulting in better execution and cost savings. Oxera 2020 also noted that MiFID II unbundling requirements had reduced execution costs for end-investors.

3.42 In CP 21/9, we removed research on issuers with a market cap below £200m from the inducement requirements, but concluded that there was no merit in more broadly reversing the protections and benefits for investors from unbundling. Noting the limited supply and demand for SME research, we deemed it unlikely that material costs would be transferred back to investors via increased trade execution costs.

3.43 We now examine potential impacts on investor costs, from five perspectives:

- Costs from changes in research consumption
- Costs from impacts on best execution
- Costs from changes in trading volumes
- Costs from changes in, and transparency of, research pricing
- Other cost-related considerations

Costs from changes in research consumption

3.44 This section looks at past changes to investment research spend in the UK, how significant such research costs are for asset managers and investors, and what the impact of introducing changes may be to future costs. Where possible, it makes comparisons to non-MiFID "bundled" jurisdictions.

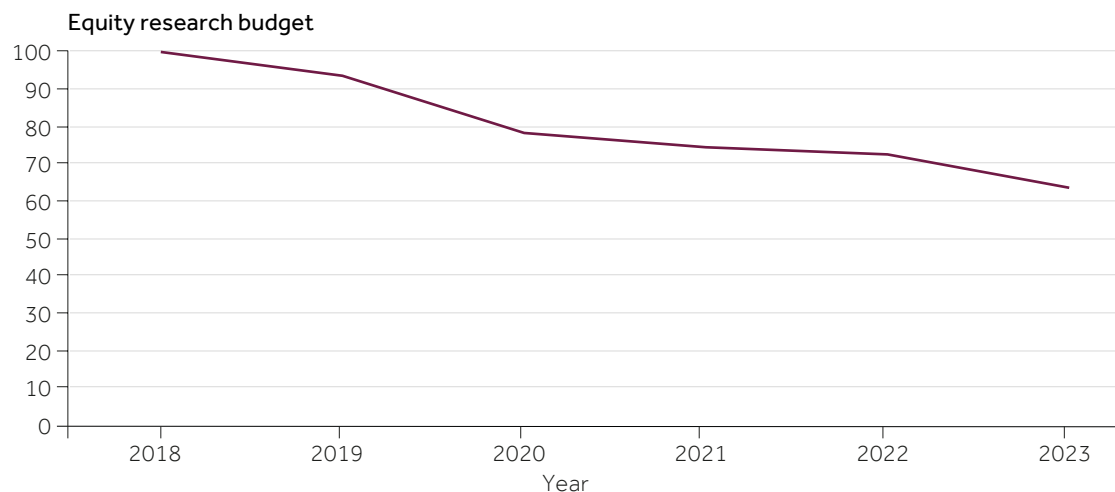
3.45 Our industry engagement and submissions received suggests that UK spending on investment research from the introduction of MiFID II to the present has fallen by circa 30%-40%. This is consistent with the outcomes of the FCA 2019 review, taking into account the differing time periods. However, the data we reviewed as part of our engagement suggests that there have also been significant declines in major non-MiFID

jurisdictions too, with some sources suggesting falls of a similar magnitude, questioning the link to MiFID II. Most data submitted also indicates that the decline in research spending had largely flattened out by 2023.

3.46 In terms of the causes of this decline in research spend, many market participants referenced some of the long-term trends in UK equity markets previously noted (see 3.18), rather than the unbundling requirements of MiFID II. Declines were also believed by many respondents (including asset managers) to represent a more efficient consumption of research after the unbundling reforms of MiFID II. Others indicated that they also represent a change in the balance between internally generated and externally procured research in response to MiFID II. In other words, some asset managers invested in growing their in-house research capabilities as a substitute for reduced external research procurement. It is challenging to quantify this growth in internal research capabilities on a consistent basis across asset managers of different sizes, business models, and group/subsidiary structures.

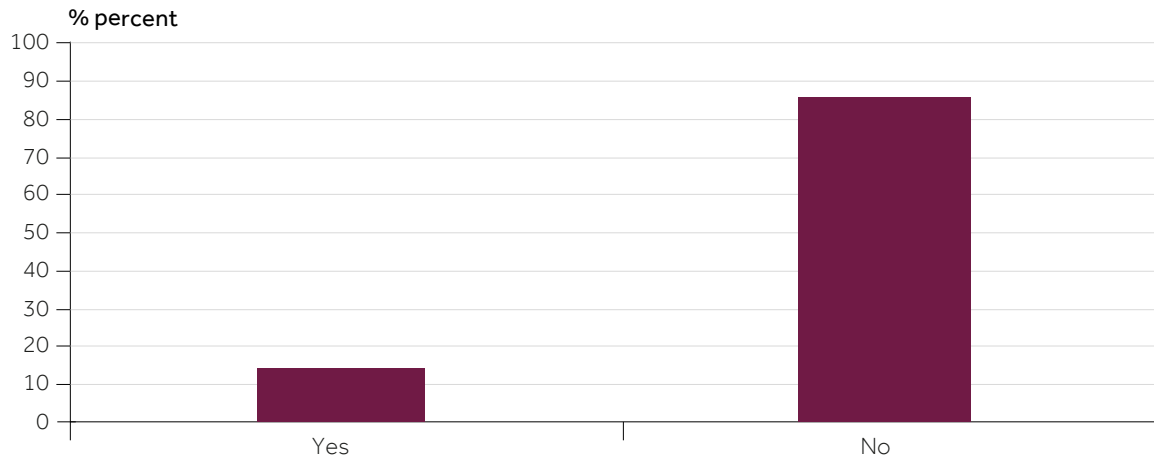
3.47 Via its firm survey, the FCA sought to verify such trends in research spending. In this we found that research spend had fallen by 36% from 2018 to 2023, in line with prior observations under 3.45 above. (Unfortunately, the smaller number of firms able to provide data for 2017 precludes including a number for that year.)

Figure 7: Research budget set for externally purchased equity research across asset managers, indexed to 2018



3.48 However, the above declines are in externally purchased research, and do not reflect other source of research, including firms' own internal capabilities. In our engagement and survey the subset of firms that had made changes to their investment process as a result of MiFID II indicated they had invested significantly in internal research resource and expertise to replace their consumption of external research.

Figure 8: Are there ways in which the MiFID II requirements on research procurement have led to changes in how investment research is undertaken as part of your firm's equity investment process?



3.49 In terms of how significant research costs are for asset managers and investors, we note that averages are not representative, as research costs vary greatly depending on the asset class, business model and investment approach of a firm. For instance, passively managed investment in liquid, developed market, large cap equities may have very different research costs to actively managed investment in less liquid, developing market, small cap equities.

3.50 During our industry engagement, there were contrary views on the materiality of research costs.

- Some market participants noted that research is a small charge to investors as a percent of assets under management, but a large cost when transferred to the own resources of asset managers. It was consequently considered that the level of focus by investors is disproportionate to the actual costs. However, at the same time market participants asserted that research spending should increase, implying that charges will not necessarily remain at these levels.
- It was acknowledged that third party research costs charged to their own resources could indeed be borne by investors instead of asset managers (e.g. via increased management charges), so that they are not an additional expense to asset managers. However, other market participants pointed out that competitive factors mean this has not generally been the case, as asset managers often compete on "headline" management costs and are reluctant to raise these.

3.51 In our firm survey, we sought to examine the costs of equity research relative to equity assets under management and revenues since the introduction of MiFID II. The challenges of firms providing such data precluded us from drawing very definite conclusions. However, we would note that:

- Externally purchased equity research as a proportion of equity assets under management was in a range of 0.01% to 0.03% for the period 2018-23 across those firms sampled. Within that range, it approximately halved over that period. While averages may not be representative, it supports the assertion of market participants during our engagement that typical research costs are in "low basis points".

- Externally purchased equity research as a proportion of total revenues earned from equity assets under management was in a range of 4% to 5% for the period 2018-23 across those firms sampled. Within that range, it fell only slightly over that period. However, such averages are not representative, especially when viewed in isolation from firms' overall business models, profitability and internal research capabilities. Hence, they cannot in themselves support or refute an assertion that purchasing external research is a significant cost when transferred to asset managers.

3.52 It would be informative to compare such cost levels to jurisdictions not subject to MiFID II and which already work to a bundled payment model, such as the US. However, such comparisons have limitations. This is because the scope of what services can actually be bundled with trade execution as "soft commissions" in such jurisdictions is not comparable to the UK, as such jurisdictions generally facilitate a broader range of services to be bundled. Consequently, a simplistic comparison could inflate an estimate of the costs of introducing a bundled model, while a more structured comparison is not possible with the data and disclosures available across jurisdictions. Jackson and Zhang 2022 and 2023 provide samples of disclosed research costs as a proportion of assets under management for select US funds, which are in a range that is not dissimilar to those we identified above (i.e. "low basis points"). However, other evidence submitted suggests that US research spending under a bundled model can be significantly higher than that of European asset managers using their own resources under MiFID II.

3.53 In a bundled model, it can be also insightful to examine what proportion of total commissions are dedicated to research services, as opposed to trade execution. Jackson and Zhang 2022 and 2023 found that under a bundled model in the US, research services can remain a high and sticky proportion of commissions, typically 40%-60%, and not reducing even as trade execution costs decrease. Such levels of research spend as a proportion of bundled commissions are similar to those of the UK prior to MiFID II unbundling reforms (with evidence suggesting 60%-65%). In our firm survey, we sought to verify trends in research expenditure relative to trade execution costs since the introduction of MiFID II. Once again, there were challenges receiving such data in a standardised or comparable form. However, externally purchased equity research as a proportion of commissions spent on trade execution was in a range of 40% to 65% for the period 2018-23 across all firms sampled. A moderate decline in the ratio over that period changed to an increase in 2021. It is notable that such spending levels are approximately equal to the proportion of soft commissions dedicated to research spend in a bundled environment, both in the US now and in the UK before MiFID II. This could be interpreted to imply that research spend, when viewed relative to trade execution spend (with which it was previously bundled), has not actually changed significantly since the introduction of MiFID II.

3.54 Overall, we conclude that research expenditure and hence investor costs have declined since the introduction of MiFID II, but they have not declined significantly relative to trade execution costs (which they were previously bundled with), and some of this decline has been offset by the growth in (non-conflicted) internal research capabilities. We also conclude that average, industry-wide external research costs are relatively low, both as a proportion of assets under management and asset manager revenues (although averages may not be representative, especially when take out of context of

a firm's overall business model and profitability). These are important considerations when comparing potential harms across different payment options, under which either firms or clients could bear such costs.

Costs from impacts on best execution

- 3.55** Asset managers in scope of this consultation are bound by best execution rules. Under these, firms have an obligation to take all reasonable steps to obtain the best possible result for their clients. Research services are not a factor in assessing best execution. It is not envisaged that it is necessary to revisit the rules on best execution (see Chapter 4), and our engagement with industry confirm their view of this position. Consequently, no additional costs to investors are expected specifically due to best execution considerations. Absent such a stance, increased costs to investors would be both higher and more difficult to quantify, as they would potentially consist of not just increased payments for research, but also increased trade execution costs to procure such research.

Costs from changes in trading volumes

- 3.56** Even with best execution in place, there could be increased costs to investors if asset managers have an incentive to trade more to gain access to research that is provided alongside execution services. As noted in CP 21/9, if trade execution costs are not included in "headline" fund management costs, managers may also be less incentivised to control for such costs. However, such overconsumption of research would still lower net returns and hence performance measures, after all charges are taken into account. Consequently, asset managers should not be incentivised to do so, unless the reduction in return is not material enough to be a sufficient deterrent. Nonetheless, this potential conflict of interest makes transparent cost disclosure an important potential safeguard for investors, and so is considered in Chapter 4.

Costs from changes in, and transparency of, research pricing

- 3.57** The MiFID II reforms were intended to ensure research could be priced transparently and separately. There is a risk that the introduction of bundled payments could reduce transparency and foster opaque charging structures, and thereby also increase the price of research on a "per unit" basis.
- 3.58** In FCA 2019 we found that the market for separately priced research emerging after MiFID II was still nascent, and the price discovery process was not yet mature. There were also concerns that levels of pricing for research were very low.
- 3.59** Engagement and data/evidence submitted ahead of this consultation suggested a similar pricing environment to FCA 2019.
- On *transparency* of pricing, while research costs are indeed separately attributable as an expense, there is still not full maturity in how research is separately priced. Pricing consistency among market participants for comparable services is low, and pricing can often reflect and possibly be correlated with other factors (e.g. the provision of other services between the producer and consumer).

- Regarding *levels* of pricing, the pricing of research is still considered low, though some suggested that research providers with a strong franchise can maintain firm pricing. We have also seen evidence that research price declines have largely bottomed out. It was suggested that in jurisdictions in which firms can pay with client money on a bundled basis, research is generally priced higher on a "per unit" basis. This potentially higher pricing of bundled research prompted mixed responses. Some market participants asserted that the higher costs of research are necessary to promote broader capital markets benefits. However, others raised concerns on potential increased cost to their clients, should a bundled model be introduced.

Other cost-related considerations

- 3.60** Under the Consumer Duty (on which, see Chapter 2), firms must provide products and services that represent fair value. In their implementation of a new option, we would expect firms to consider whether the Consumer Duty applies and, if so, how they comply with the relevant rules.
- 3.61** Our industry engagement also pointed out there is a risk of customer harm and conflicts of interest arising from cross-subsidisation of research costs between different clients, especially should there only be partial usage of a new payment option (e.g. some clients opt out). Such risks could also arise from cross-subsidisation across investment strategies, and across client types, if there is not fair allocation of costs among clients on the same payment option.

Conclusion

- 3.62** We conclude that the additional research costs that could be borne by investors vary by business model and investment strategy (but in aggregate are not high, as a proportion of assets under management), and that preserving best execution rules should prevent additional costs from poorer trade execution. However, there is a risk that bundled pricing may lead to overconsumption of research, increased prices for the same level of consumption, and opacity in the evolution of costs borne by investors. It is important that the guardrails around a new option capture such risks, to avoid undue costs or harms to consumers. This is covered in Chapter 4.

Competition

- 3.63** The practice of bundling trade execution and research can raise competition concerns. These include reduced price transparency impeding competition, and competitive advantages for full-service brokers (offering both execution and research) over execution-only brokers and IRPs (each offering only one of these). When changes were introduced under MiFID II, it was expected that they would result in improved competition in the markets for both research and execution services.
- 3.64** In FCA 2019, we found that competition had driven down costs for written research, enhanced price transparency (but price discovery was still evolving), and led to increased use of a wider range of counterparties for execution services. However, we also found competition concerns, including that levels of research pricing had become very low

and that cross-subsidising of research could have occurred, making it difficult for IRPs to compete. We also noted that over-cautious approaches to the new rules might be impeding firms from onboarding new research providers.

3.65 In CP 21/9, when we proposed exempting research on SMEs from the inducement rules, we expected our proposals to have modest benefits in terms of competition. It was expected that increased asset manager interest in purchasing SME research as a result of the exemption would lead to improved profitability for firms providing such research, potentially attracting new entrants. However, we also recognised the potential negative competitive impacts already outlined above. Overall, we considered the effects on competition were likely to be positive but limited, given the low existing levels of SME research supply/demand. However, it was noted that the same changes might be anti-competitive in other market segments that already had adequate levels of research (i.e. beyond SME issuers).

3.66 Our industry engagement for this consultation reiterated many of the same competition concerns raised above, i.e. that reduced spend and more efficient consumption of research (see 3.18 and 3.46) had led to downward pricing pressures, potential cross-subsidisation of research activities, a smaller number of research providers, little space for new entrants or innovation, and hesitancy for firms to onboard new research providers due to increased procurement processes/frictions arising from MiFID II requirements. Other impacts raised were that MiFID II had caused more research expenditure to go to the top providers of research, and hence increased concentration in the research market (although evidence and data was not specific to the UK).

3.67 Competitive considerations specific to certain types of firms are detailed below, focusing on issues not already covered above, and also on what our subsequent engagement and survey has revealed.

Asset managers

3.68 The first consideration that arose from our engagement and analysis was whether unbundling creates a competitive disadvantage for smaller asset managers. It was asserted that when MiFID II was introduced, larger asset managers had more in-house research capabilities, so external research spend was a smaller component of their cost base, and consequently could be more readily absorbed into their own resources. Whereas smaller asset managers had less in-house research capabilities, relied more on external research, could not absorb so much of this external research spend into their own resources, and so had to cut more of their research expenditure. It was also asserted that because larger managers absorbed research costs into their own resources, it became more difficult for smaller asset managers to compete without doing so too. Evidence submitted to us supported that the larger falls in research spend have been among smaller asset managers. This was also considered to be a forward-looking issue, i.e. the viability of any new payment model depends on the competitive dynamics of its uptake by firms of different sizes.

3.69 The second consideration was whether unbundling hinders new entrants into the asset management market. It was asserted that building adequate internal research capabilities can be a large set-up cost, whereas accessing research via bundled trading

commissions is more scalable with firm size, and hence better able to facilitate new entrants, and thereby promote increased competition. It is plausible that purchasing research through bundled payments is more likely to scale with the growth of a firm’s assets under management (notwithstanding some upfront set-up costs, e.g. establishment of a CSA), especially should growth in assets under management be correlated with growth in trading volumes.

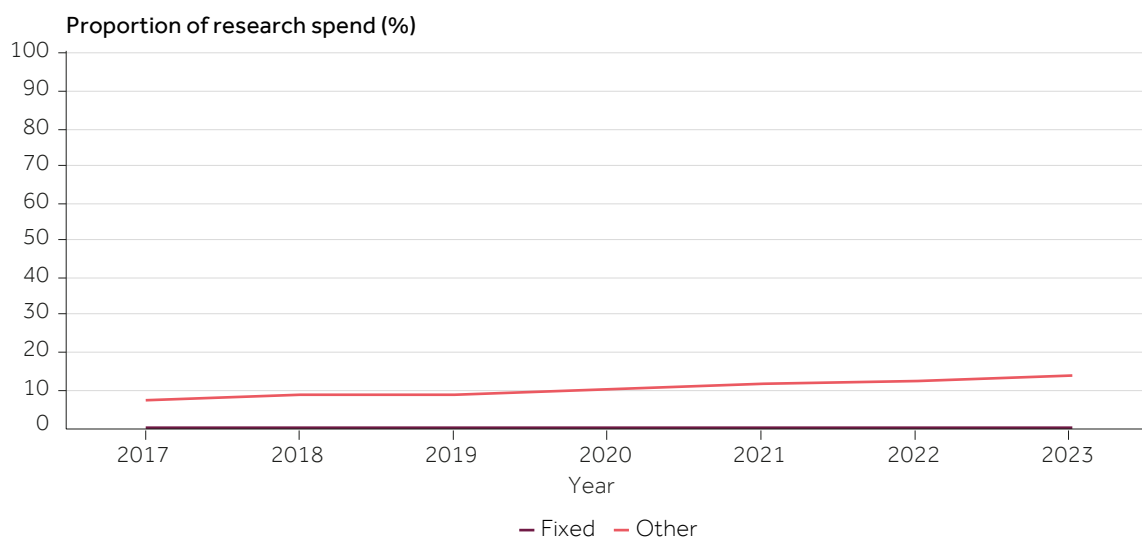
3.70 The third consideration was that where RPAs are used, it is primarily smaller asset managers that use them, as they have less ability to absorb costs into their own resources. Asset managers noted particularly the following features of RPAs as difficult to implement.

- The requirement that monies for the purchase of research are regularly swept into a bank account under control of the firm.
- The challenges of attributing the value, and hence attributing the costs, of research at the client level.
- The low level of latitude in requirements for budgeting in research purchases.

3.71 It was asserted that the operational complexities and resource-intensive nature of maintaining RPAs consequently fall mostly on such smaller firms, making them less competitive. We have taken such complexities into account in proposing the features of a joint payments option in Chapter 4.

3.72 In our industry survey, we found that overall usage of RPAs was low, having grown from 5% to 10% of revenue spend between 2017 and 2023. However, we also found that RPA usage was highest among smaller firms (those that are “flexibly” supervised on a portfolio basis under the FCA supervisory model). There was no uptake of RPAs among larger firms in our sample (i.e. those that are supervised on a “fixed” basis through a dedicated team under the FCA supervisory model). We also found that firms currently using RPAs were more interested in using the new payment option when compared with firms who do not use RPAs. However, we note these firms only make up a small proportion of our survey respondents, and all had been previously identified as having a specific interest in our proposals.

Figure 9: Take-up of RPAs by firm classification under the FCA supervisory model



3.73 We conclude that a new option could improve the competitive landscape by providing a more scalable and less operationally complex means of research procurement, especially for smaller asset managers. However, as asset managers often compete on the basis of management charges, to ensure a level competitive playing field it is also important that any new option be appropriately captured in cost disclosures to investors. This is considered in Chapter 4.

Brokers

3.74 The principal consideration raised in our engagement was that reduced budgets and the low price of research had made the economics of selling research challenging on a stand-alone basis. It was asserted that full-service banks and brokers (offering both trade execution and research) had been able to maintain research coverage, either via cross-subsidisation with other business lines (as a “loss leader”) or due to a lower cost base (economies of scale). It was asserted that smaller and niche brokers that sought to compete had higher costs, fewer economies of scale, and fewer business lines to cross-subsidise a loss-leading activity from. This had led to consolidation and exits, thereby reducing competition.

3.75 Looking forward, it is plausible that the introduction of a new option could have positive competitive benefits, by increasing the overall demand for research and reducing frictions in purchasing it, to the benefit of brokers whose business model is less diversified and more reliant on it. An increase in the price of research might also have positive benefits for such firms’ business models, stabilising the fragile business model of some incumbents and attracting new entrants. However, this would be with accompanying investor costs covered previously.

3.76 Finally, keeping best execution requirements unchanged (see 3.55) should mean that execution-only brokers do not face increased competitive challenges from brokers offering bundled execution and research. There is however still a risk that trade execution is directed to specific brokers to ensure continued access to research. However, industry engagement suggested that an appropriate structure for the allocation of payments between research providers should largely mitigate such risks (analogous to CSAs in the US), as they allow commissions paid to one broker to be used to procure research from another broker or IRP.

Independent research providers

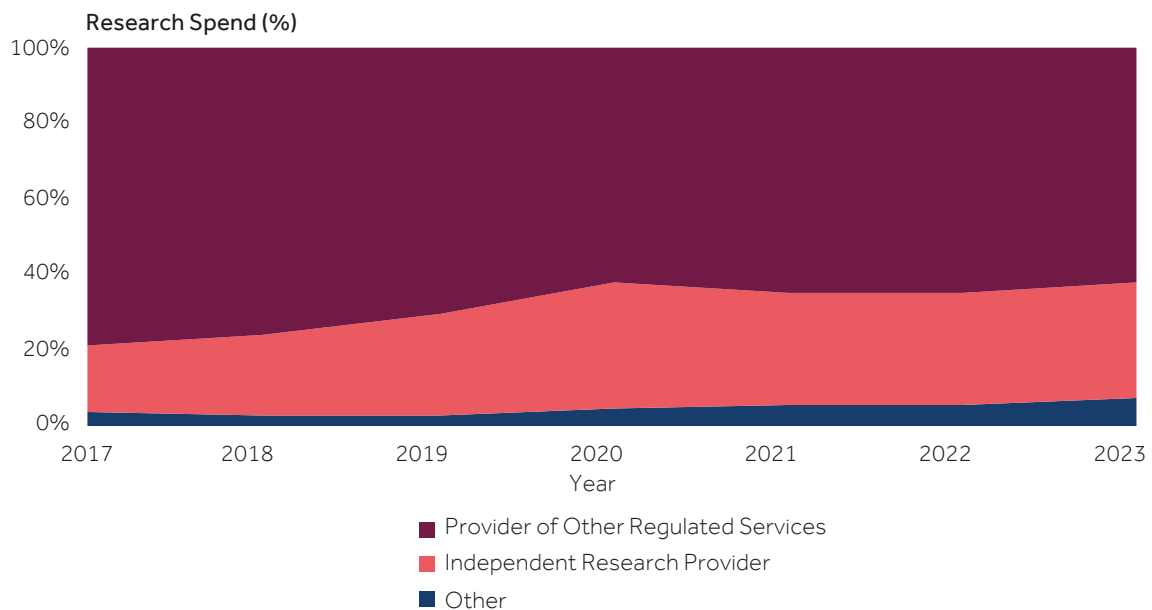
3.77 Among IRPs, the considerations raised were largely those already noted in 3.66 above. Additionally, the overwhelming majority of IRPs do not believe that the exemptions from inducement rules for research produced by IRPs, which were introduced under CP 21/9, delivered any benefits to them. One interpretation of this could be that the inducement rules of MiFID II are not actually the determining factor in enabling effective competition. An alternative interpretation could be that the research procurement processes introduced under MiFID II have created operational rigidities in research procurement that hinder more dynamic competition among providers.

3.78 Evidence submitted to the FCA showed a decrease in the number of IRPs providing research since the introduction of MiFID II. However, other evidence submitted suggests

that the decline in research spend with IRPs has fallen by levels that are comparable with that of most types/sizes of brokers, and that the post MiFID II revenue declines among IRPs recently seem to have largely bottomed out. Nonetheless, it is plausible that many IRPs face challenges similar to those of small brokers (higher costs, fewer economies of scale, fewer business lines to cross-subsidise from), and they may consequently be facing similar market structure changes (including acquisitions and exits), as well as ongoing impacts where some of the intended benefits of MiFID II have not been as effective as others (e.g. there is still not full maturity in how research is separately priced).

3.79 The FCA sought more structured data on trends in research spending by provider type via our firm survey. Figure 10 demonstrates that, for the sample of firms analysed, IRPs have almost doubled their market share of equity research spending since the introduction of MiFID II. This largely supports the conclusions of 3.78, i.e. that while total equity research spend might have declined since the introduction of MiFID II, IRPs do not seem to have been disproportionately impacted, and may indeed have benefited (at least on a relative basis) from MiFID II’s unbundling provisions.

Figure 10: Total value of payments for equity research by provider type



3.80 Looking forward, it is plausible that the introduction of a new option could have positive competition benefits for IRPs for the same reasons as those for brokers under 3.74-3.76 above. Unlike brokers, however, there may be fewer benefits in terms of the removal of procurement frictions, as IRPs were already exempted from the inducement rules under CP 21/9. As with execution-only brokers, there is a risk that a bundled payment option could raise competitive challenges, as IRPs cannot offer both research and trade execution on a bundled basis. However, industry engagement suggested that an appropriate structure for the allocation of payments between research providers (akin to CSAs in the US) should largely mitigate such risks. It was indicated that even in jurisdictions that operate under bundled models, IRPs can competitively thrive when these are in place. This is taken into account in the proposals of Chapter 4.

Other considerations

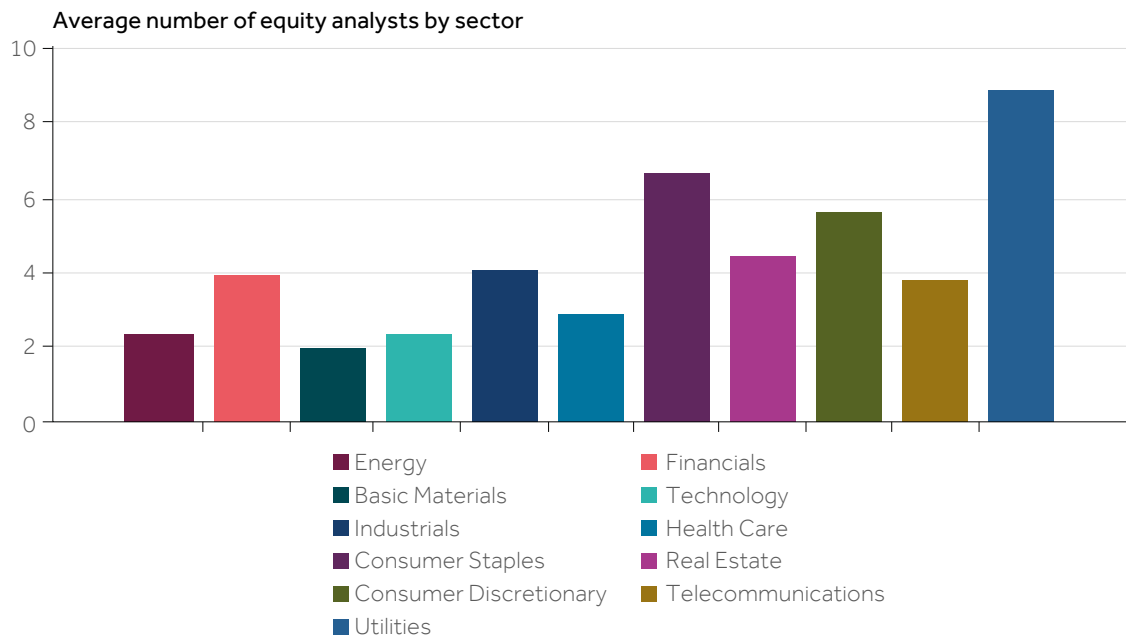
- 3.81** There is an overall risk that the introduction of bundled payments could reduce price transparency and foster opaque charging structures, making it harder for investors to evaluate and compare pricing, which could have anti-competitive impacts. This is taken into account in the proposals of Chapter 4, where we seek to ensure that research costs continue to be priced separately.

Competitiveness and growth

Competitiveness and growth of UK equity markets and listed companies

- 3.82** In 3.8-3.29, we explored whether improving the informational efficiency of equity markets via increased levels of investment research could have a positive impact on market functioning, liquidity, costs of trading, price discovery, valuation, cost of capital, and investor performance. These topics were explored from the perspectives of market integrity and consumer protection; they are here explored instead from a competitiveness and growth perspective.
- 3.83** Industry engagement suggested that issuers may be less likely to list in the UK if there are diminishing research capabilities and analyst coverage levels. However, market participants also generally considered research to be among the lesser explanatory factors behind decreased listings in UK equity markets. They also accepted that increased research would not in itself reverse such trends, absent other equity market reforms. Nonetheless, they emphasised research as part of an overall environment for listings, and maintained that the factors that strengthen such an environment are symbiotic. More specifically, it was claimed that increased demand and higher pricing for research via a bundled option could facilitate brokers investing in better and more innovative research capabilities for UK equity markets.
- 3.84** Through industry engagement we sought data and quantitative evidence on the causal chain between investment research and choice of listings domicile. However, while we received submissions on relevant trends in UK listings, we did not receive any data or evidence on the causal link with research coverage. This parallels the prior analysis on market functioning (3.8-3.29) and capital access/costs (3.30-3.33), where the theoretical basis for causality is plausible, but empirical evidence is low. We nonetheless chose to analyse whether research may be underserving sectors of the UK capital markets that are important for economic growth.
- 3.85** Firstly, we examined analyst coverage of small cap companies, as these can often include firms with fast-growing and innovative business models. This is covered under 3.23-3.25, where we concluded that any declines in coverage for most small cap firms generally pre-dated MiFID II.
- 3.86** Secondly, we examined analyst coverage in the Information Technology and Health Care sectors (the latter as a proxy for life sciences), which are generally considered to be high growth sectors. Figure 11 shows that average analyst coverage in these sectors is quite low at 2.3 for Technology and 2.9 for Health Care.

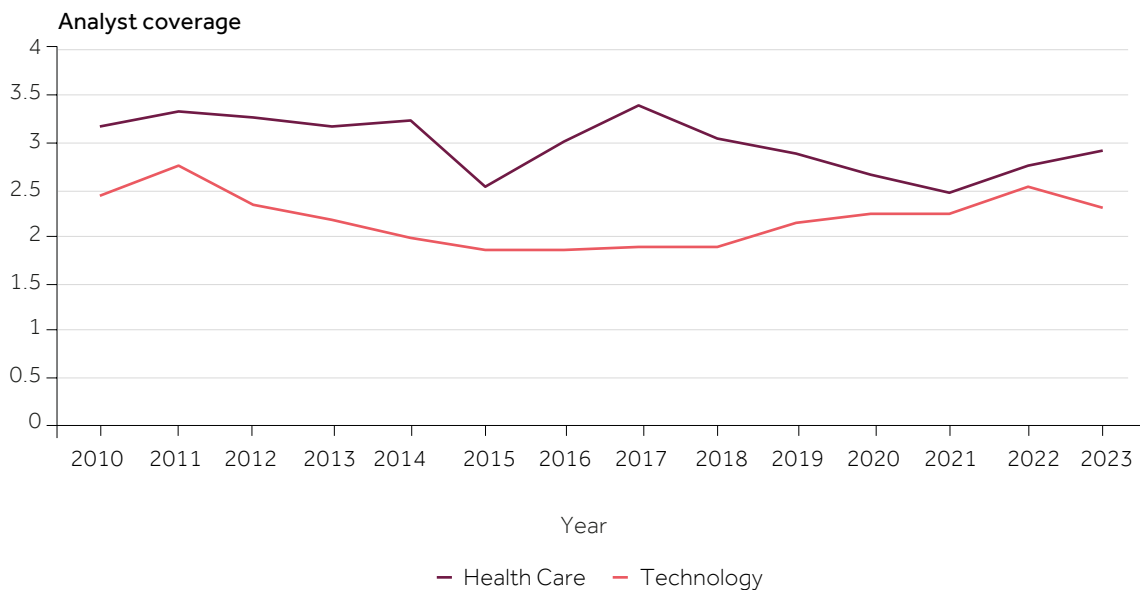
Figure 11: Average analyst coverage by sector (2023)



Source: FCA, Bloomberg

3.87 Figure 12 shows that analyst coverage in these sectors has fluctuated over the time period studied. However, there is no evidence to suggest that the unbundling reforms introduced in MiFID II have had a significant effect on coverage in these sectors.

Figure 12: Average analyst coverage over time for the Health Care and Technology Sectors



Source: FCA, Bloomberg

3.88 In our industry survey we also explored research spending on these two sectors. However, the challenges of firms providing data in a standardised and comparable form

precluded us drawing any conclusions. We also sought views from asset managers on whether there were any countries, geographical regions, sectors (which would include UK health care and technology companies, as well as other industry sectors) and capitalisation strata (which would include UK SMEs, but also larger capitalisation UK companies) on which they were unable to secure adequate research. The response of the overwhelming majority of respondents was that there were none.

Figure 13: Are there any countries, geographical regions, sectors or capitalisation strata for which you consider you are unable to secure adequate (combining quantity and quality) research coverage to support your current investment processes?

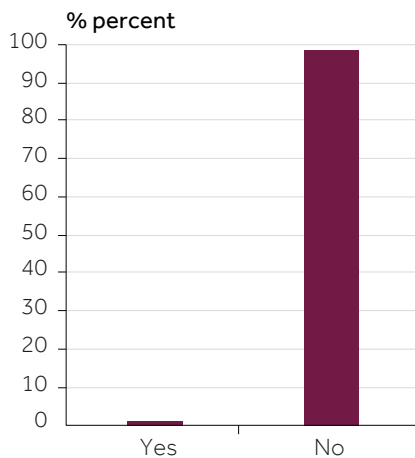
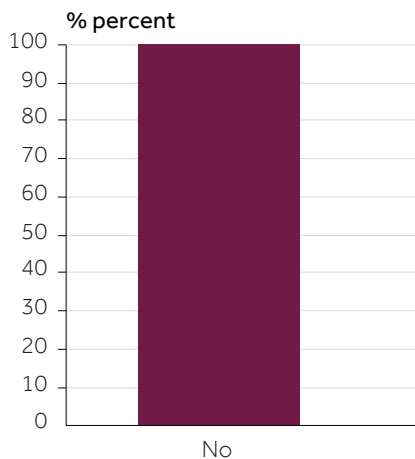


Figure 14: Are there any countries, geographical regions, sectors or capitalisation strata for which you have withdrawn investment strategies since 2017 because of difficulties in securing adequate (combining quantity and quality) research coverage?



Competitiveness and growth of UK asset managers

3.89 Industry engagement suggested that there may be challenges to UK asset managers seeking to procure research from other jurisdictions that operate under a bundled payment model. This has competitiveness considerations, as UK asset managers may be better able to compete globally if they can access global research from a broad range of jurisdictions with a sufficiently wide range of payment models.

- 3.90** For instance, the US regulatory framework requires brokers-dealer to register as an investment advisor to accept unbundled payments. In July 2023 an SEC no-action letter expired which had allowed US broker-dealers to accept separate payments for research services provided alongside execution services from clients that are subject to the MIFID II unbundling rules. This may have impeded the ability of UK asset managers to obtain some research. Furthermore, the EU regulatory framework – with which the UK framework has heretofore been largely aligned – is now also evolving towards a model that also facilitates research payments on a bundled basis.
- 3.91** Industry engagement placed much emphasis on this consideration of asset manager competitiveness. This was mostly framed as avoiding unnecessary impediments to having a globally aligned research procurement approach that can operate flexibly across multiple jurisdictions. Evidence submitted indicated that asset managers overwhelmingly prefer to procure research under a single global programme, albeit with the capacity for regional modifications. There were comparatively fewer concerns raised on actual inability to access critical research from other jurisdictions.
- 3.92** In our firm survey we sought to understand the overall impact of MiFID II on asset managers' ability to procure research. We found that the majority of firms did not consider that MiFID II had impacted either the quantity or quality of research available to them, although 14% of firms said it had a negative impact on quantity and quality.

Figure 15: What impacts has MiFID II had on the availability (quantity) of investment research to your firm?

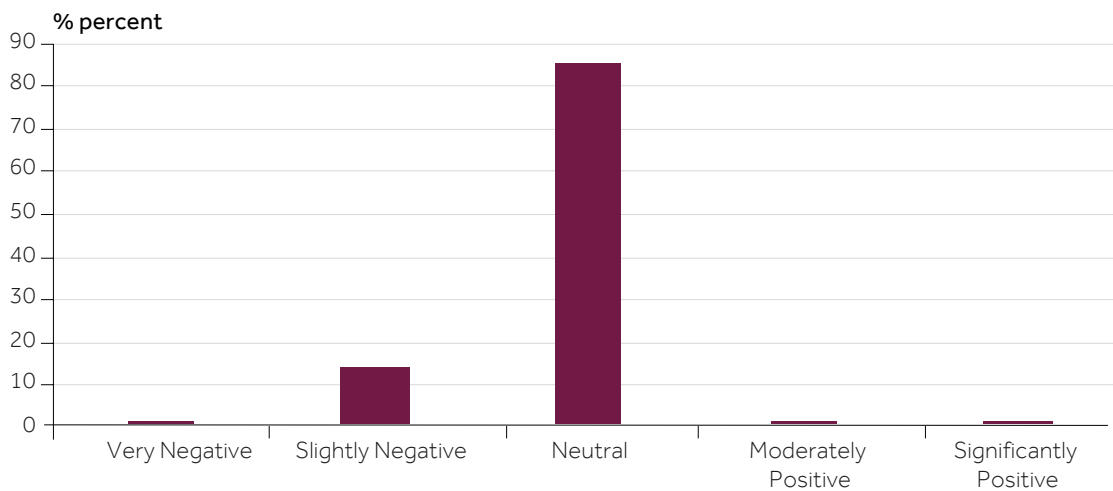
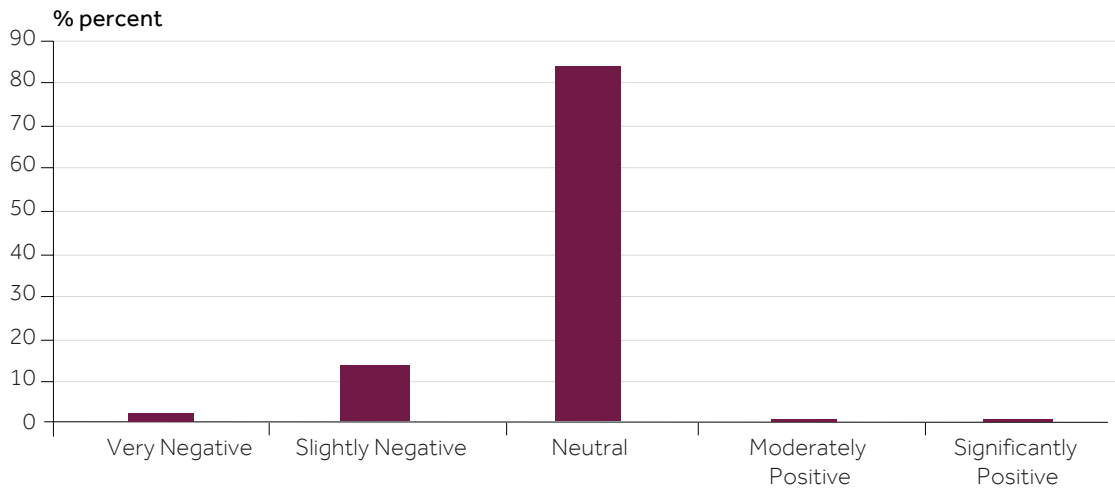


Figure 16: What impacts has MiFID II had on the quality of investment research available to your firm?



3.93 We also found that most firms did not think MiFID II had impacted their ability to purchase research from overseas jurisdictions, nor that the expiry of the SEC no-action letter had any material impact on their ability to access the research they needed.

Figure 17: What impact has MiFID II had on the availability (combining quantity and quality) of investment research specifically from providers in overseas jurisdictions?

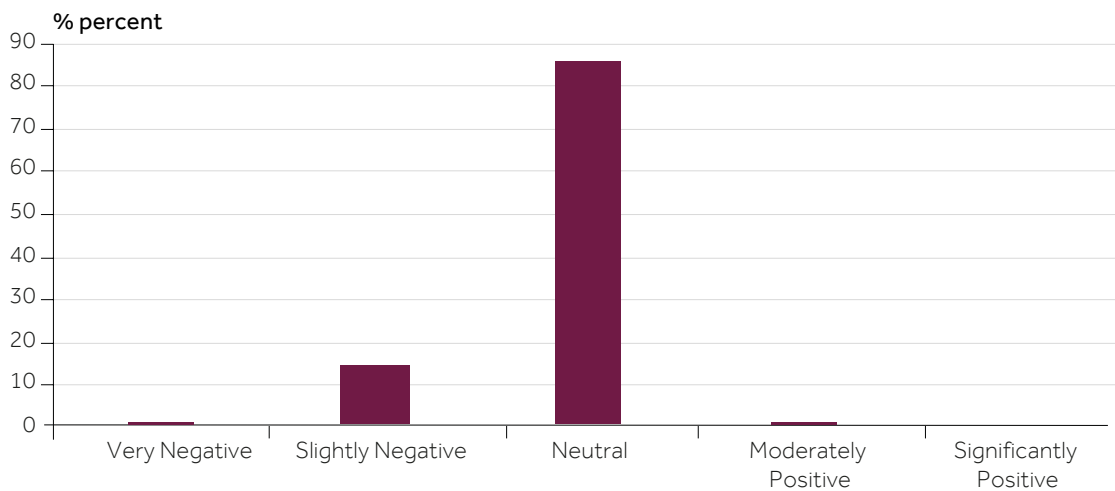
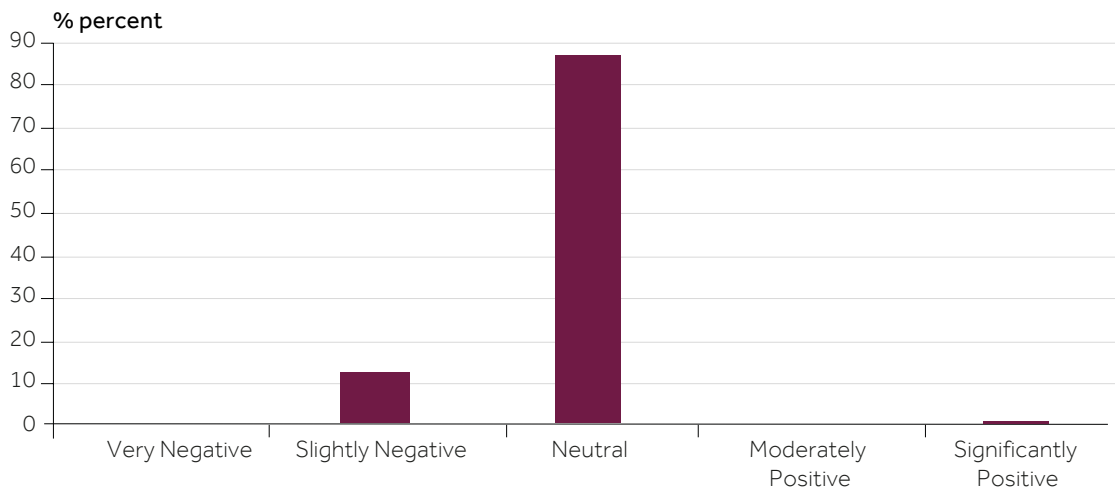
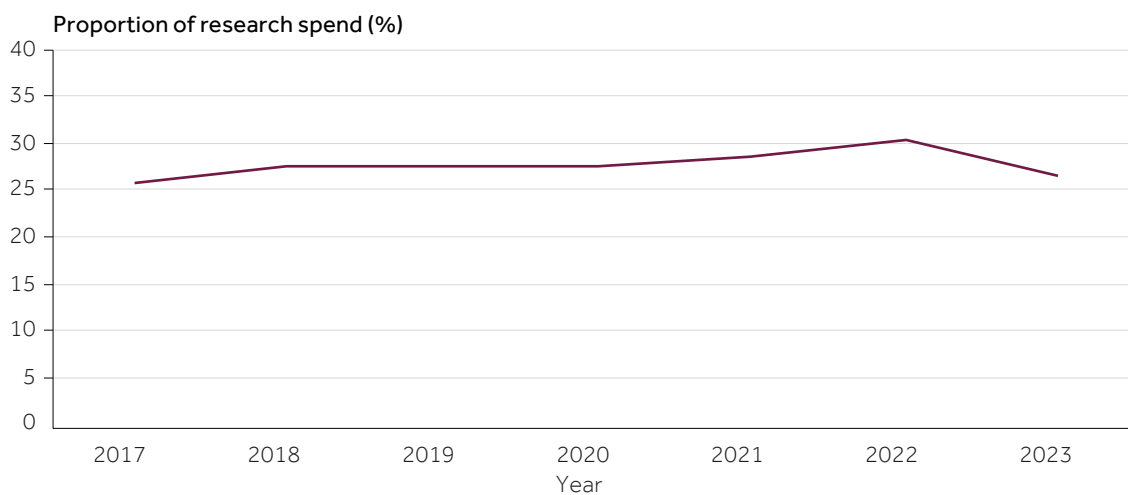


Figure 18: What has been the impact on your firm’s access to investment research of the expiry of the SEC no action letter on MiFID II unbundling requirements?



3.94 However, our survey also evidenced that a high proportion (more than 70%) of equity research purchased by UK asset managers is purchased from overseas providers. This means that, even if such asset managers are receiving the research they require (as was indicated under Figure 17 above), the extent to which UK rules for investment research are aligned with those of other jurisdictions could drive how operationally efficient it is for them to purchase such research.

Figure 19: Proportion of equity investment research spend by UK asset managers accounted for by UK domiciled providers



3.95 Overall, we conclude that there is little evidence of negative impacts arising from MiFID II on the international competitiveness and growth of UK equity markets and listed companies. However, the current research payment options could hinder the operational efficiency of UK asset managers, in particular when the proportion of research purchased from overseas is considered, which may be relevant to their international competitiveness.

Question 7:

- a. Do you agree with the findings set out in the Analysis section of this consultation paper? [Yes, No, No View]**
- b. If yes or no, please explain your views.**

Chapter 4

Our proposals

Introduction

- 4.1** In this chapter we restate the proposal of the IRR for the high-level attributes of a new payment option and set out the proposed new option being consulted on. All the considerations in Chapter 3 collectively provide the following backdrop to the proposal of a new payment option.
- 4.2** When viewed at a very high level, there are two potential clusters of possible harms to be mitigated that could inform the framing of a new option.
- 4.3** The first is the potentially negative impact of the current rules on the market integrity and functioning of UK equity markets, the cost of and access to capital for UK firms, valuation levels and investment returns, and by extension the competitiveness and growth of the UK economy. This is asserted by some in qualitative terms, although there is little quantitative evidence that the current regulatory regime on research might be a significant cause of such harms.
- 4.4** The second is the potentially negative impact of the current rules on the ability of UK asset managers to purchase equity research, especially across multiple jurisdictions, without significant and potentially disproportionate operational and regulatory complexities. Significant harms that could arise under this premise have not been evidenced, i.e. UK asset managers do not seem to be facing a widespread lack of access to critical research, and there is little evidence of negative impacts on UK investors' investment performance. However, there may be more straightforward, albeit long-term, benefits to be gained in enabling greater operational efficiencies for firms with diverse business models to purchase research across multiple jurisdictions. It may also be a benefit to smaller firms, especially if these are new entrants or fast-growing firms, to have a new option that is less complex and resource-intensive to operate compared to RPAs, and is more likely to scale in line with their business growth.
- 4.5** In framing our proposal for a new payment option, the second set of considerations plays an important role.
- 4.6** Turning to the potential risks of introducing a new option, these can also be considered in two clusters.
- 4.7** The first is with respect to the increase in, or reallocation of, costs.
- A new option must ensure that the costs of research purchased are transparent to those bearing such costs, and that any overconsumption is deterred and detected on a timely basis.
 - It must also ensure that such costs are allocated fairly among clients, including clients that have elected for different payment options.

- It must ensure that disclosures on costs are comprehensible to a broad range of investors with different levels of sophistication, albeit without creating any disproportionate or unnecessary operational distinctions.
- It must not unnecessarily undermine the operation of other requirements, for instance requirements on best execution.

4.8 The second is with respect to choice and competition.

- The introduction of a new option should not make existing options unviable, or impel market participants to cease to offer these existing options. This is because the co-existence of three sufficiently differentiated options provides increased levels of choice to investors and firms, and facilitates a broader range of investment aims and business models. In this respect, Bender et al note academic literature that supports mixed pricing systems for investment research being optimal, as long as these (and their relative costs) are transparent.
- The marginal impact on competition in the research and trade execution markets should be positive, including its impact on the ability of IRPs, execution-only brokers, and small- to mid-size brokers offering a modest or specialised set of execution and research services to compete with large banks and brokers offering a broader and more comprehensive range of such services.

4.9 Our overarching approach is to remove any unintended consequences of the existing rules, while obviating the reappearance of harms that preceded MiFID II. In parallel, we remain cognisant of relevant regulatory developments in other jurisdictions, thereby seeking to ensure that any rules changes do not impose unnecessarily burdensome cross-border compliance costs on firms.

IRR recommendations on a new option

4.10 The IRR made the following recommendations.

4.11 Additional flexibility should be built into the rules, so that buy-side firms have the option of being able to pay for research using one of the following methods:

- out of their own resources
- by making a specific charge directly to their clients in respect of the costs of research
- by **combining the cost of research with execution charges**

4.12 Buy-side firms that use investment research should:

- **allocate the costs of research fairly** between their clients, having regard to the obligation on regulated firms to treat their customers fairly;
- **have a structure for the allocation of payments** between the different research providers - such as Commission Sharing Agreements;
- **establish and implement a formal policy** regarding their approach to investment research and how it is paid for;

- **periodically undertake benchmarking or price discovery** in relation to the research that the firm uses; and
- **make appropriate disclosures to the client**, which could include:
 - whether it pays for that research only using its own resources or whether it expects the client to fund the cost of the research (either through a specific charge or bundled payments)
 - where the firm’s clients are expected to fund the cost of the research:
 - what the expected aggregate cost of that research (across all its clients) would be for a defined period; and
 - how the firm intends to collect the charge (i.e. through a specific charge, a bundled charge or a combination of these);
 - details of the firm’s policies and benchmarking arrangements; and
 - subsequent disclosure of the amounts actually made for investment research, as part of the firm’s ordinary regime for making fee disclosures (rather than as a discrete obligation). The amounts should be included in the annual report and accounts and be audited.

4.13 Sell-side firms **should not be required to facilitate payments on a bundled basis** or be able to require that buy-side firms use bundled charges.

4.14 It **did not propose that the specific consent** of the buy-side’s underlying clients to these arrangements would be mandatory, but this would be subject to any pre-existing contractual arrangements between the parties or existing (non-research-related) regulatory obligations that require consent.

4.15 It recommended that the **FCA should identify and remove any barriers** in the current rules to achieving the additional flexibility being recommended.

4.16 It recommended that the UK should **seek to remain aligned with other key jurisdictions** (in particular the US and EU) in relation to research rules, where appropriate, to avoid being at a competitive disadvantage. It recommended that the UK should in any event remove any barriers which prevent UK buy-side firms from paying for investment research in other jurisdictions where payment on a bundled basis is standard practice in that jurisdiction.

Industry feedback on a new option

4.17 Industry engagement prior to our survey provided a range of views. Some asset managers asserted that they had done a lot to adapt to the MiFID II requirements and were reluctant to reverse this. Other asset managers countered that they would benefit greatly from being able to bundle, would move to a new model as soon as possible, and increase their research spend accordingly. The most prevalent view was that increased optionality would enable certain firms and their clients to decide which payment option

worked best for them, but that a widespread near-term transition to a new option would not necessarily occur. There was also a general view that a new option should not be overly prescriptive, but should also not enable reversion to a bundled model that lacked discipline, transparency and controls.

- 4.18** Many firms expressed a desire for any new model to align as well as possible with the CSA model used in other major jurisdictions. It was often expressed that it might best balance procurement flexibility with investor protection considerations, while also providing the latitude to operate globally, and fostering a broad range of research providers (including those that do not provide trade execution).
- 4.19** There was consensus that a new option should be a specific carve-out from MiFID II inducement rules. This was seen to be preferable to implementation via acceptable minor non-monetary benefits, as undertaken in PS 21/20, due to the interpretative complexities this can cause. With very few exceptions, most firms thought that sub-categories (such as distinctions by issuer market capitalisation, or between retail and institutional investors) would create operational workflow complexities that would likely hinder uptake of any new option.
- 4.20** In terms of potential features of an option, industry engagement brought out the following.

Budgets

- 4.21** The budgeting process was generally perceived as introducing a discipline which should be maintained. It was suggested that how budgets are set (e.g. at the firm, asset class, strategy or team level), with what frequency (e.g. quarterly, annually), and what governance this is subject to (both internally and with clients) should not be overly prescriptive, provided this is clearly disclosed. Many asset managers suggested that requiring investor approval of the budget should not be necessary if firms are required to have a robust policy and framework in place for budgeting. Others noted that there should not be hard caps on spending, including a requirement for advance client approval, as this would either make the operation burdensome or incentivise setting such caps very high.

Quality assessments

- 4.22** A robust process for assessing the quality of research procured on a periodic basis, and how it added value to the investment process and created better outcomes for investors, was considered an important discipline which should be maintained.

Value

- 4.23** It was considered important that the value of research should be determined, so that such value and costs can be distinguished from the trade execution with which it is bundled. There were no strong views on whether determination of value should be before or after services are received.

Cost allocation

- 4.24** It was recognised that fair allocation of research costs among clients should be achieved to avoid cross-subsidisation. However, it was thought to be challenging to attribute and hence disclose the costs of all discrete research items to specific clients or funds. It was generally believed that ensuring fair cost allocation at the investment strategy level might be more appropriate, particularly if this were combined with appropriate disclosure requirements.

Research provider allocation

- 4.25** There was strong support for a structure for the allocation of payments among research providers, similar to CSAs, for reasons already outlined above. However, it was not suggested that requirements be introduced about how asset managers actually allocate their expenditure to individual research providers, or different types of research provider (e.g. brokers, IRPs).

Disclosure

- 4.26** There was a consensus that disclosure is a critical guardrail. Regarding costs, most participants concurred that it should be part of the ordinary cost disclosures that investors receive, rather than as a discrete item. While some market participants believed that cost disclosure at the client/fund level would be challenging, others asserted that this is not the case. Some evidence suggested a preference for the disclosure of estimated research costs in advance (with changes subsequently confirmed), rather than actual research costs retrospectively. Other disclosures suggested, aside from costs, included the types of research purchased, methodologies for selecting research providers and the value they provide, and the most significant research providers. It was suggested that some of this information be available only on request. While there were suggestions of other types of disclosure (e.g. segmentation of research provider types), these were without the same breadth of support. There was little support for disclosure of what might be commercially sensitive information, such as overall firm-level research budgets and amounts paid to specific research providers.

Control of research funds

- 4.27** Some respondents expressed a preference for a CSA-like model, in which funds for research purchase accrued via trade commissions could be held with a broker, instead of RPA-like arrangements, in which they would periodically be swept to a bank account controlled by the asset manager. The operational requirements for maintaining control of research funds in separate client accounts was not always felt to justify the benefits in terms of reduced counterparty risk. It was also suggested that, while there should be requirements to ensure reconciliation of such funds is sufficiently frequent and timely, these not be overly prescriptive so as to accommodate as many different operating approaches in as many different jurisdictions as possible. However, some market participants opined that any payment mechanism for release of funds to research providers should not be significantly in arrears, to foster financial resilience within a competitive research market.

Client consent

- 4.28** It was generally perceived that a regulatory requirement to receive consent for use of the new option should not be required, that notification and disclosure to existing and new clients (as appropriate) should be sufficient, albeit subject to any pre-existing contractual arrangements between parties. It was noted that if consent is required, and only partial consent is received among clients within similar investment strategies, this might raise issues with fair allocation of costs among them (as covered above). More generally, asset managers foresaw operational challenges with having mixed payment options within a single firm or investment strategy, and believed that a regulatory requirement for client consent might exacerbate this.

Trading commentary

- 4.29** FCA engagement with market participants at the time of the expiry of the SEC no action letter (see 2.8) highlighted challenges facing UK asset managers receiving research from US firms that are registered both as broker-dealers and investment advisors. Such dual registration can occur when a US firm wishes to provide research services to clients on both a bundled and unbundled basis. In such circumstances, certain types of short-term trading commentary may have to continue to be provided by the broker-dealer (which may not be able to receive unbundled payments) rather by the investment advisor (which may be able to receive them).
- 4.30** In introducing a new option for bundled payments, UK firms that choose such an option would be able to receive such short-term trading commentary on a bundled basis from such a broker-dealer, however UK firms using existing payment options (RPAs, own resources) may not be able to receive them on an unbundled basis from the investment advisor. This could create unintended differences in access to research, to the detriment of existing payment options (RPAs, own resources). Furthermore, as such short-term trading commentary is closely linked to trade execution, it is appropriate to make any adjustments alongside introduction of the bundled option.
- 4.31** For this reason, our proposed changes include adding to COBS 2.3A.19R(5), commentary and advice linked to trade execution to be among the acceptable minor non-monetary benefits for all payment options. Although this consultation is focused on introducing a new payment option for research, and not on reassessing the scope of eligible research services (as noted above), the linkage of such services with trade execution and the unintended disadvantaging of other existing payment options are reasons to not delay such a change. Reconsidering the status of trading commentary is also not among the recommendations of the IRR, though the topic is noted in the summary of responses in Appendix 3 of the report.

Summary of survey guardrail responses

- 4.32** In our survey we sought views on potential features of a new payment option, by assessing the likelihood of firms using a new payment option should it contain various features. We found that for half of respondents there was an unlikely/undecided *overall* stance on whether they were likely to use a new option (whatever its features), and for only half of respondents it *depended* on the potential features of the option. Among

those that demonstrated preferences among guardrails, there was a marginally reduced propensity for respondents to consider using the option with either:

- a “counterparty guardrail”, i.e. a requirement that monies for the purchase of research under bundled payments are regularly swept into a bank account under control of the firm; or
- an “all-in fee basis points disclosure guardrail”, i.e. a requirement that firms disclose to clients fees that include research payments, expressed as a proportion of assets under management.

4.33 There was much less distinction in views between the other guardrails, and even the discrimination among the two requirements above was only moderate.

Figure 20: Likelihood of using a new payment option (firm responses across all guardrail questions), showing the proportion that responded consistently across all guardrail questions vs the proportion that provided responses that varied by guardrail

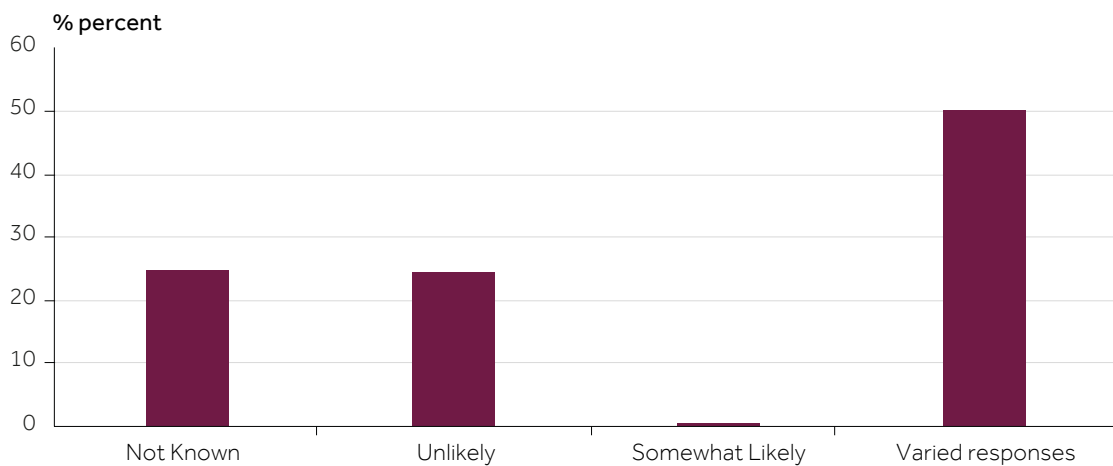
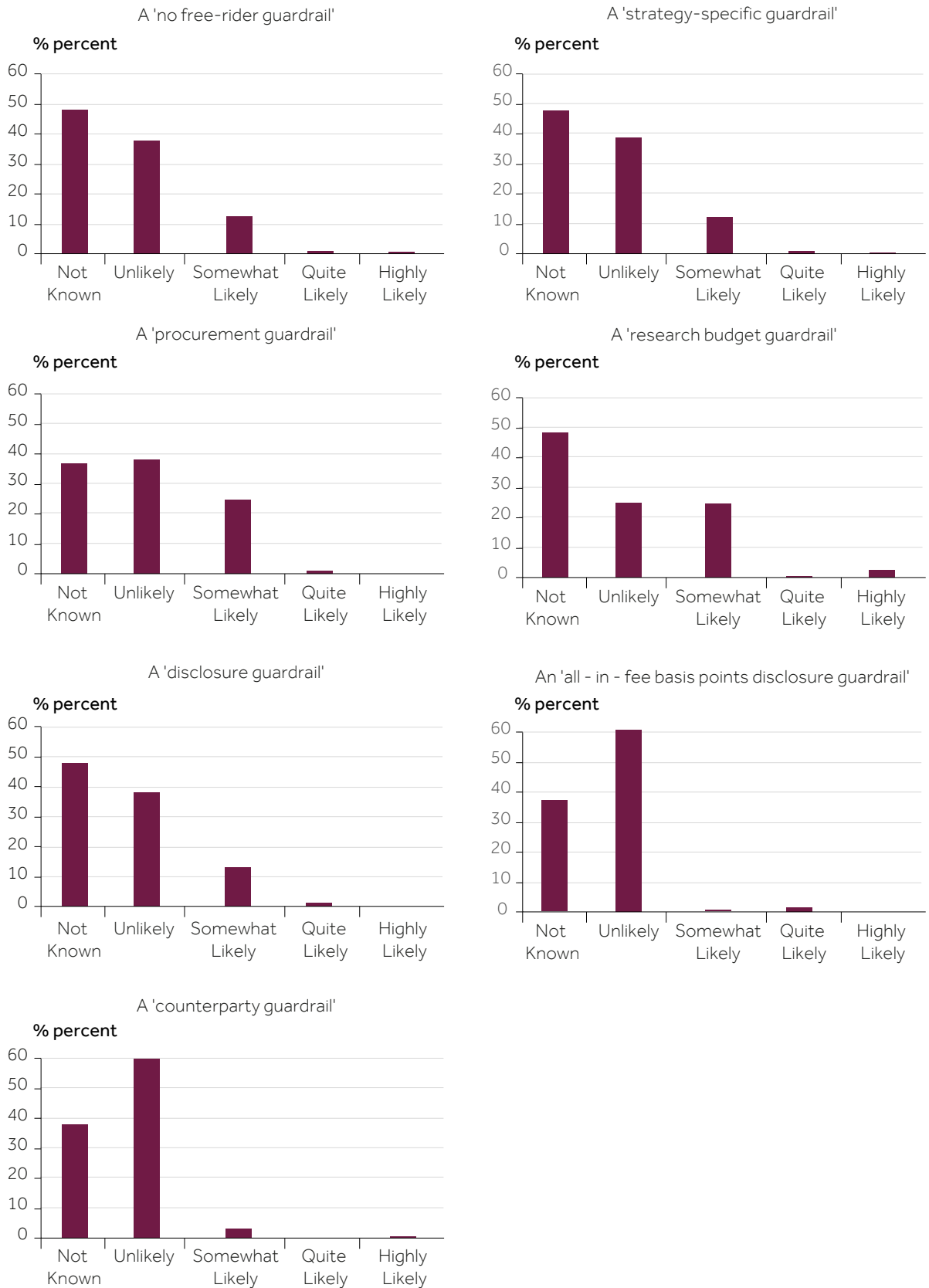


Figure 21: What is the likelihood of your firm using a new payment option for research if its requirements included?



4.34 Please see Annex 4 for the exact specification of guardrails in the chart above.

Proposal

4.35 Taking into account the considerations above, we propose a new option that facilitates bundled payments for third-party research and execution services. This option will exist alongside those already available, i.e. payment from a firm's own resources, and payment from an RPA.

4.36 We propose that a firm must meet the following requirements in relation to the operation of the new option, as set out in the draft amendments to COBS in Appendix 1.

4.37 A formal policy describing the firm's approach to bundled payments, including with respect to governance, decision-making and controls, and how these are maintained separately from those for trade execution.

- This is intended to set out the firm's approach, and hence underpin, a number of other considerations and guardrails that immediately follow; these are each set out separately below. This is also intended to preserve the benefits of existing requirements on best execution.

4.38 An agreement with research providers on the methodology for calculating and separately identifying the cost of research.

- This is intended to promote price discovery and transparency in investment research, impede the growth of opaque charging structures, and support competition in the market for separately priced research.

4.39 A structure for the allocation of payments between research providers, including IRPs.

- This is intended to maintain competition in the market for research services, including between full-service brokers, smaller and specialist brokers, and IRPs. It also enables alignment with the payment allocation structures typically used in other jurisdictions (e.g. CSAs). It thereby enables asset managers to access global research from a broad range of jurisdictions, with a sufficiently wide range of payment models, and without significant and potentially disproportionate operational and regulatory complexities.

4.40 Operational procedures for the administration of accounts used to purchase research, and for the delegation of such responsibilities to others. This includes that reconciliation and reporting for such accounts is undertaken with an appropriate frequency and timeliness, that timely payments are made to research providers, and that risks arising from unspent surplus amounts and research provider concentrations are monitored and managed. However, it does not include RPA-like arrangements in which monies are periodically swept to a bank account controlled by the asset manager.

- This is intended to ensure sufficient responsibility and accountability for the administration of such accounts by asset managers, while not implementing more prescriptive requirements in which the benefits (in terms of reduced counterparty

risk) might not outweigh the costs (in terms of reduced alignment with operating approaches in other jurisdictions). Prompt payment to research providers should also foster financial resilience within the research market.

- 4.41** A budget to establish the amount needed for third party research, reviewed and renewed at least annually, and based on expected amounts needed to purchase such research as opposed to volumes or values of transactions. If the research charges to clients exceed this budget, or the budget is increased, the firm's policy must set out the relevant actions to be taken and information to be disclosed to clients.
- This is intended to maintain discipline in costs borne by clients, avoid overconsumption of duplicative or low-quality research, and prevent inappropriate influence of research procurement considerations on trade allocation decisions. However, it is intended to do so with greater flexibility in implementation of controls than existing RPA requirements.
- 4.42** An approach for the allocation across clients of the costs of research purchased through bundled payments, appropriate to the business model of the firm, but ensuring its outcome is fair such that the relative costs incurred by clients are commensurate with relative benefits received. The specific cost of individual investment research items need not be discretely attributable to individual clients, but the approach should be reasonable and its outcome fair across all clients.
- This is intended to mitigate the risk of customer harm arising from unfair allocation of research costs between different clients, which could arise from cross-subsidisation across investment strategies, across client types, or if certain investors consent to a bundled option but others do not. However, it is intended to do so with greater flexibility in implementation of controls than existing RPA requirements.
- 4.43** Periodic assessment of the value, quality, use and contribution to investment decision-making of the research purchased, as well as price benchmarking of such research against relevant comparators, to be undertaken at least annually.
- This is intended to ensure that the incremental costs of research are sufficiently weighed against the incremental benefits to asset managers and investors in its contribution to the investment process, and that the prices paid for such research are reasonable compared to prices paid by other market participants.
- 4.44** Disclosure to clients on: the firm's use of bundled payments, the key features of its approach to implementing this payment option and meeting the relevant requirements, if and how bundled payments are combined with any other payment option, the most significant research providers, and costs incurred.
- This is intended to support clients' ability to have sufficient information to make good decisions on their choice of asset manager, to address potential asymmetries of information on the amount and type of research spending, and to provide transparency and accountability on costs incurred.

4.45 It is confirmed that research services are not a factor in assessing best execution, and the best execution rules of COBS 11.2 continue to apply unchanged.

- This is intended to preserve the benefits of existing requirements that are working as intended, and prevent the choice of a higher-cost provider of trade execution services for the purpose of accessing its research. It is also intended to maintain competition in the market for trade execution services separate to that for research.

Question 8:

- a. Are there any features of the proposed payment option and associated guardrails that would positively or negatively impact its take-up by firms? [Yes, No, No view]**
- b. If yes or no, please explain your views.**

4.46 As noted in 4.29-4.31, in the US, certain types of short-term trading commentary may be provided by a broker-dealer (which may not be able to receive unbundled payments) rather than by an investment advisor (which will be able to receive them). This could create unintended differences in access to research, to the detriment of existing payment options (RPAs, own resources). For this reason, our proposed changes include adding to the list of acceptable minor non-monetary benefits for all payment options in COBS 2.3A.19R(5) short-term trading commentary and advice linked to trade execution.

Question 9:

- a. 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)? [Yes, No, No view]**
- b. If yes or no, please explain your views.**

4.47 As noted in Chapter 3, the option for bundled payments to purchase research on companies with a market capitalisation below £200 million introduced through PS 21/20 has had little take up. Taking account of this, the fact that the new option for bundled payments can apply to research on companies of any size, and to avoid additional complexity in the rules, we are proposing that the specific rule relating to SME research in COBS 2.3A.19R(5)(g) is deleted. However, we are retaining COBS 2.3A.19R(5)(h) to (k) that were also added through PS 21/20, which includes treating corporate access in relation to companies with a market capitalisation below £200 million as a minor non-monetary benefit.

Question 10:

- a. 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)? [Yes, No, No view]**
- b. If yes or no, please explain your views.**

4.48 The proposals are also intended to balance the following considerations.

- Promoting effective competition among asset managers by introducing a new payment option that is more operationally efficient than RPAs, and may thereby improve the ease with which new entrants can enter the market and be more scalable for small but fast-growing firms.
- Facilitating the international competitiveness of UK asset managers, by aligning the option with rules governing payments for research in other jurisdictions, and providing operational efficiencies for asset managers with diverse business models to purchase research across multiple jurisdictions.
- Securing an appropriate degree of protection for consumers through guardrails to ensure sufficient discipline around budgets for research spending, fair allocation of costs to clients, value assessment, price benchmarking of research purchased, and cost transparency.
- Reflecting industry feedback on the potential features of a new option, avoiding features whose operation may be unnecessarily burdensome relative to their benefits (such as the counterparty guardrail), but preserving features that may be necessary when considering the range of FCA objectives (such as a cost disclosure guardrail).
- Preserving the aspects of research procurement approaches introduced under MiFID II that have been beneficial and operated as intended.
- Increasing choice and avoiding unnecessary regulatory costs, by introducing a new option while keeping existing options unchanged.

4.49 The rules and guidance that underpin the new option can be found in Appendix 1.

Question 11: **Are there any further comments you wish us to consider while finalising these proposals? If so, please include here.**

Annex 1

Questions in this paper

Question 1:

- a. Do you agree with our proposal to create additional payment optionality for investment research? [Yes, No, No view]
- b. If yes or no, please explain your views.

Question 2:

- a. Would you be likely to take advantage of the proposed new payment option? [Yes, No, No view]
- b. If yes or no, please explain your views.

Question 3: Do you have any views on key indicators that could act as success measures for the outcomes we are looking to achieve?

Question 4:

- a. 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, No, No view]
- b. If yes or no, please explain your views.

Question 5:

- a. Do the guardrails we are proposing around firms' use of the proposed payment option secure an appropriate degree of protection for consumers? [Yes, No, No view]
- b. If yes or no, please explain your views.

Question 6:

- a. 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? [Yes, No, No view]
- b. If yes or no, please explain your views.

Question 7:

- a. Do you agree with the findings set out in the Analysis section of this consultation paper? [Yes, No, No view]
- b. If yes or no, please explain your views.

Question 8:

- a.** Are there any features of the proposed payment option and associated guardrails that would positively or negatively impact its take-up by firms? [Yes, No, No view]
- b.** If yes or no, please explain your views.

Question 9:

- a.** 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)? [Yes, No, No view]
- b.** If yes or no, please explain your views.

Question 10:

- a.** 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)? [Yes, No, No view]
- b.** If yes or no, please explain your views.

Question 11: Are there any further comments you wish us to consider while finalising these proposals? If so, please include here.

Question 12: Do you have any comments on our cost benefit analysis?

Question 13: 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.

Annex 2

Cost benefit analysis

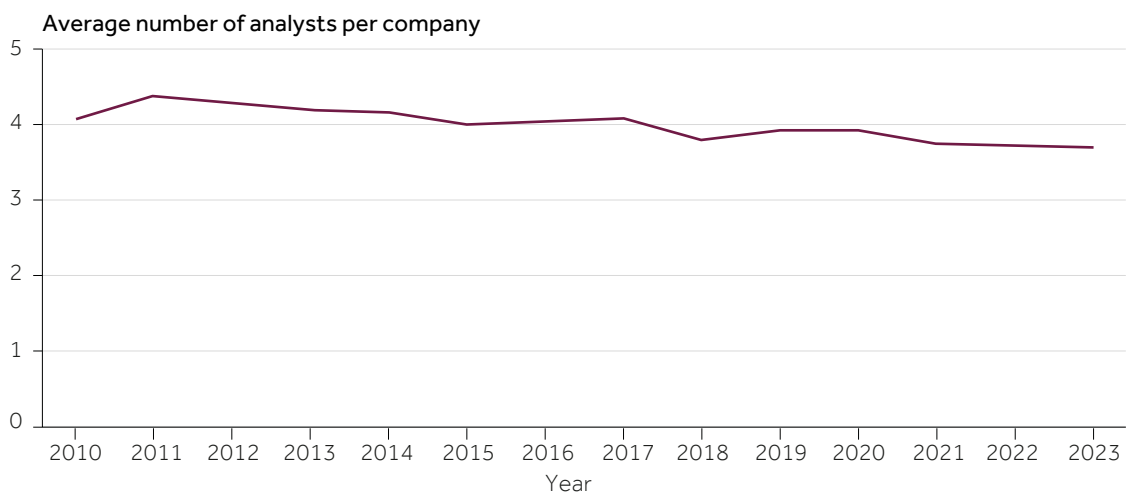
1. The Financial Services and Markets Act (2000) requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as 'an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made'.
2. This analysis presents estimates of the significant impacts of our proposal. We provide monetary values for the impacts where we believe it is reasonably practicable to do so. For others, we provide a qualitative explanation of their impacts. Our proposals are based on weighing up all the impacts we expect and reaching a judgement about the appropriate level of regulatory intervention.
3. The CBA has the following structure:
 - The market
 - Problem and rationale for intervention
 - Options assessment
 - Our proposed intervention
 - Baseline and key assumptions
 - Summary of impacts
 - Benefits
 - Costs
 - Wider economic impacts
 - Monitoring and evaluation

The market

4. Investment research plays a crucial role in providing information to potential and existing investors to allow them to understand a publicly traded company and assess the risks connected with the investment. Investment research may cover an individual company, may compare companies in the same or similar sectors, or may address broader thematic topics.
5. Many investors in public capital markets utilise investment research to varying extents. "Buy-side" professional asset managers and investment advisers will use investment research to help identify and assess investment opportunities on behalf of their clients. Institutional investors or "asset owners" (including insurance companies and pension funds) may also utilise research for similar purposes.
6. "Sell-side" brokers and traders will use investment research to support their own trading strategies and, thereby, help support market liquidity.

7. Retail and non-institutional investors may also use investment research to inform their own investment decisions, although investment research (other than issuer-sponsored research, as described further below) tends to be less readily available to them.
8. 'Sell-side' investment research is produced by analysts employed by investment banks, brokers and other financial institutions who provide execution and brokerage services. Most such UK-based financial institutions will have such analyst capability.
9. Investment research is also produced by analysts who are not connected with investment banks, brokers or other financial institutions providing execution and brokerage services. These providers are often referred to as "independent" research providers.
10. Historically, brokerage firms typically 'bundled' research costs with transaction commissions (i.e. the cost charged to clients to trade). However, this historic arrangement was altered with the UK Markets in Financial Instruments Directive (UK MiFID) collection of laws that regulate the buying, selling and organised trading of financial instruments. The rules, derived from European Union (EU) legislation, took effect in November 2007 and were revised in January 2018 (MiFID II). UK MiFID rules on inducements prevent UK asset managers from purchasing research with so-called "soft commissions" (i.e. bundled payments), whereby payments for execution and research are combined. This requirement placed on UK asset managers stems from MiFID II and was intended to bring transparency to opaque charging structures and manage conflicts of interest.
11. Subsequently, firms receiving research were required to either pay for research themselves from their own resources or agree a separate research charge with their clients. Most asset managers have not agreed a separate research charge but pay for their research out of their own resources.
12. Prior to MiFID II's implementation, there was already a gradual decline in the coverage of UK public companies, with the average number of analysts covering each UK public company dropping from a high of c.4.5 in 2011 to under 4. This trend has persisted post-MiFID II, as Figure 1 shows, with the average number of analysts per UK public company now closer to 3.5.

Figure 1: Average number of research analysts covering UK public companies

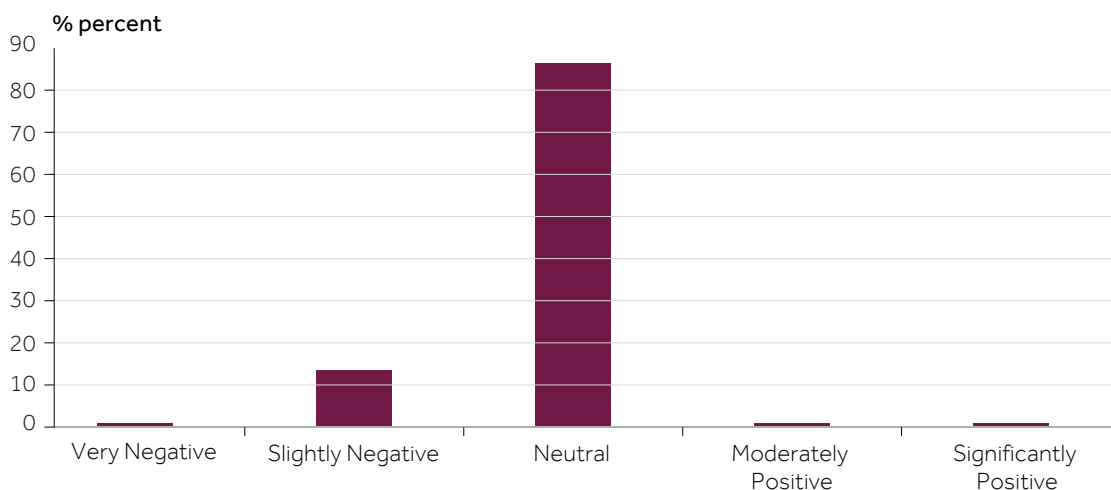


Source: FCA, Bloomberg. All dates correspond to November of that year

Problem and rationale for intervention

13. The UK Government's Edinburgh Reforms, which aim to drive growth and competitiveness in the financial services sector, included the publication of the IRR. The IRR concluded that the MiFID II unbundling requirements have had adverse impacts on the provision of investment research in the UK, and that this might have potentially negative impacts on capital market depth and funding available to UK companies, which may in turn ultimately hinder UK economic growth prospects.
14. In addition, the US regulatory framework creates challenges around the acceptance of unbundled payments for research. This presents barriers for UK asset managers that are subject to MiFID II to buy research from US broker-dealers. In 2017, the SEC issued a no action letter to alleviate these barriers temporarily, and give time for the market to adjust. The relief expired in July 2023. While there is limited evidence that there is currently a significant constraint on the ability of UK asset managers to access research by US providers, we expect that this will restrict use of such research on the margin.
15. Our survey of asset managers undertaken in Q1 of this year found that most asset managers said that the impact of MiFID II on the availability of investment research had been neutral. Less than 15% of asset managers surveyed said that the impact of MiFID II on availability of investment research had been negative, while very few said that it had a positive effect. With respect to the SEC's relief expiring, 12% of asset managers said there had been a negative impact of the expiry of the SEC no action letter on MiFID II unbundling requirements on access to investment research.

Figure 2: What impacts has MiFID II had on the availability (quantity) of investment research to your firm?



16. However, while there may have only been a limited negative impact on UK asset managers' access to investment research, some asset managers have experienced some frictions when accessing research under MiFID II rules. These frictions can manifest themselves in excessive access costs. This is particularly true when accessing research from US brokers, as the two sets of rules can conflict, unless the broker-dealer

also registers as an investment advisor. These costs can arise from the time and effort required to arrange access to research. We would expect at least some of these higher resource costs to be passed on to investors through management charges.

17. Thus, for some parts of the market, these restrictions can have an impact on the FCA's top-line outcome of fair value in financial markets as it raises costs and prices for investors using UK asset managers.

Options

18. This consultation paper arises from the IRR recommendation to allow additional optionality for paying for investment research.
19. We are aware that there is a risk that bundled pricing leads to increased and inefficient consumption of research, increased prices for consumption of the same research, an unfair allocation of costs across investors, and opacity in the evolution of costs borne by investors. We therefore considered alternative specifications of the proposed option that seek to limit the principal-agent and competition problems that arise when the costs of investment research are bundled with execution costs. The types of guardrail (restrictions) that could be put in place include disclosure provided to investors and the definition of research that can be bundled in with execution costs.
20. We have considered several alternative specifications of the proposed option in the development of our policy proposals. Some of these proposals were suggested to us as part of our engagement with industry. We have proposed a set of guardrails that aim to ensure that investors are protected from the problems described above. Additional guardrails would not be net beneficial in addition to the guardrails we are proposing. For example, we considered a "counterparty guardrail", i.e. a requirement that monies for the purchase of research under bundled payments are regularly swept into a bank account under control of the firm. This was rejected because the incremental benefits from reducing counterparty risk was not proportionate to the costs, especially as this guardrail would add complexity when operating in other markets and so would put take-up at risk.

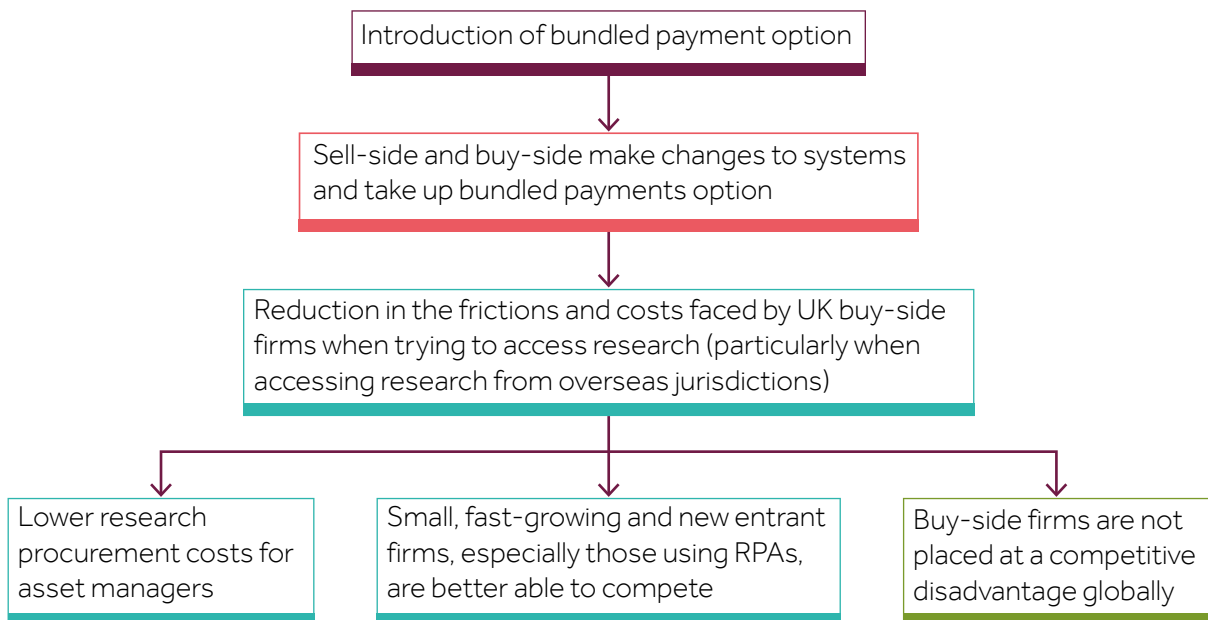
Our proposed intervention

21. We propose a new option that facilitates bundled payments for third-party research and execution services, provided that the firm meets the requirements in relation to the operation of this. This option will exist alongside those already available, i.e. payment for research from a firm's own resources and payment for research from an RPA for specific clients. The requirements on firms in relation to this new option include establishing:
- A formal policy describing the firm's approach to bundled payments, including with respect to governance, decision-making and controls.
 - An agreement with research providers on the methodology for calculating and separately identifying the cost of research.

- A structure for the allocation of payments between research providers, including IRPs.
- An approach for the allocation across clients of the costs of research purchased through bundled payments, appropriate to the business-model of the firm, but ensuring its outcome is fair such that the relative costs incurred by clients are commensurate with relative benefits received.
- Periodic assessment of the value, quality, use and contribution to investment decision-making of the research purchased, as well as benchmarking and price discovery of such research, to be undertaken at least annually.
- Disclosure to clients on the firm’s approach to bundled payments, if and how bundled payments are combined with any other payment option, the most significant research providers, and costs incurred.
- Operational procedures for the administration of accounts used to purchase research. A firm may delegate the operation of such accounts to a third party, but remains responsible for ensuring administration is undertaken with competence and in the best interests of clients.
- A budget to establish the amount needed for third party research, reviewed and renewed at least annually, and based on expected amounts needed to purchase such research as opposed to volumes or values of transactions.

22. The following chart sets out how our proposed option would reduce the harm set out above.

Figure 3: The causal chain



- Interventions
- Firm changes
- Outcomes
- Drivers of international growth and competitiveness

Baseline and key assumptions

Baseline

- 23.** We assess the impacts of the policy against a baseline, or 'counterfactual' scenario, which describes what would happen without the proposed intervention(s). That is, we compare a 'future' under the policy, with an alternative 'future' without the policy.
- 24.** We note that since MiFID II's unbundling of commissions, the majority of firms have chosen to absorb research costs into their own resources rather than negotiate RPAs with their clients. Absent our proposals, we expect that most firms would continue to fund research through their own resources, and this is our baseline scenario.
- 25.** We note that the EU is introducing legislative adjustments to the unbundling rules to offer firms further flexibility on how to pay for investment research services. This also introduces a new payment option, alongside a number of requirements which an investment firm will have to comply with if they wish to bundle research payments with execution. Consequently, under the baseline, asset managers could find themselves misaligned with EU research provision and procurement regulations, in addition to the US. Asset managers may therefore be further constrained in accessing research if the EU sell-side change their approach to providing research over time, thus making it harder for UK asset managers to purchase research out of their own resources.

Number of firms affected

- 26.** We expect that approximately 900 buy-side firms could be impacted by our proposals. However, some of these firms will not be active managers of public equity and therefore will not be affected by our proposals. Further, buy-side firms have a choice of whether they use the option to purchase bundled research or maintain their current approach to purchasing research. Our survey suggested that only a minority of firms in the population would be interested in taking up our proposals with guardrails in place. We asked firms several questions to find out whether firms would take up the new payment option if its requirements included a particular type of guardrail. For the different types of guardrail, the highest proportion of positive responses (somewhat likely, quite likely, highly likely) was always below 30% (when weighted by number of firms).
- 27.** There are also around 470 wholesale banks and brokers that are potentially affected by our proposal. However, the number of these firms affected by our proposals will be significantly less than this. This is because to be affected by the proposals, sell-side firms need to offer trading in public equity and have research capability in public equity, which many of these firms do not offer.

Key assumptions

- 28.** We make several sequential assumptions which underpin the benefits of our proposals:
- 1.** Research spend and analyst coverage are correlated
 - 2.** Levels of analyst coverage and capital market activity are correlated

3. Past and future changes in both investment research spend and analyst coverage levels are driven, at least in part, by the available payment options
4. The introduction of the bundled payments optionality will increase research production

29. We note that the first assumption is relatively intuitive, albeit not evidenced. An increase in research spend from buy-side firms would provide sell-side firms or IRPs with the incentive and resources to employ more analysts and increase their coverage. There is some academic evidence (which we discuss in the benefits section) to support the second assumption, however, we note that the evidence is mixed, and it is difficult to precisely quantify the strength of the relationship between analyst coverage and capital market activity.

30. With respect to the third and fourth assumptions, and as noted above, analyst coverage has been gradually decreasing for over 10 years. There are many possible reasons for this, including not only the available payment options (e.g. requiring unbundled payments post-MiFID II), but also a reduction in the number of listed companies in the UK, the growth of passive investing, and the growth of private/non-listed markets. It is difficult to say whether the payment options were a key factor in the reduction of analyst coverage. The data suggests that much of the decrease in coverage pre-dated MiFID II (and in any case correlation does not imply causality). However, it is possible that it is a contributing factor, and that providing firms with flexibility in how they pay for research may therefore increase spend and coverage, though there is not a substantial weight of evidence on this.

31. We also rely on a number of standard assumptions for estimating our cost and benefits calculations:

- The familiarisation costs have been calculated using our standardised cost model (SCM) and its cost assumptions. The underlying assumptions remain the same as in Appendix 1 of our [How we analyse the costs and benefits of our policies document](#).
- We also rely on assumptions in the SCM to categorise affected firms by size. The SCM categorises all regulated firms as large, medium or small using data from annual FCA fee blocks.
- The non-familiarisation costs have been calculated using responses to our survey.
- Our estimates assume full compliance with the rules. We believe this is reasonable as it allows us to establish all potential costs and benefits.
- We use 2023 prices for our cost estimates as the salary information from the SCM is from 2023.
- We consider the costs and benefits of our proposals over a 10-year appraisal period, using a 3.5% discount rate.

Data

32. We undertook a cost survey of affected market participants in January/February 2023. There were just over 800 buy-side firms identified in December 2013 with assets over £10m. We grouped together firms that were in the same business group. From this, we identified 768 different groups. The remaining groups were split into three categories:

large groups that contain fixed firms (for which there is dedicated FCA supervisory resources); groups that we identified as potentially having a specific interest in our proposals (small and mid-size asset managers, and typically those active in UK SME equities); and the remainder. We sent the survey to all fixed groups (containing the largest asset managers in the UK) and groups of special interest. We randomly selected 29 from the remainder group. In total, we sent the survey to 54 different asset managers. In total, we received 41 responses to the survey. The following table shows the breakdown of the population, the firms included in the survey and the responses we received.

Table 1: The population of asset managers and survey responses

Type of firm	Number of firms in population	Number of firms surveyed	Number of responses to survey
Fixed	14	14	13
Firms with interest in the proposals	11	11	8
Other asset managers	743	29	20
Total	768	54	41

Source: FCA analysis

33. The responses to the survey did not, however, provide meaningful cost estimates of our proposals. This may be due to several reasons. Some firms were not focussed on managing public equity and therefore they would not be meaningfully affected by our proposals. Many respondents were uncertain whether they would take up the options given by our proposals. Firms may have found it difficult to envisage the costs implementing and using the proposed bundled option without having final sight of the policy.
34. Given the small number of responses on costs, we, therefore, rely on the SCM for certain cost estimates in the CBA. Details of the assumptions and methodology used are discussed in the sections of the CBA where the SCM is used.
35. We note the changes we are proposing are not yet relevant to UCITS management companies, full-scope UK Alternative Investment Fund Managers (AIFMs), small authorised UK AIFMs and residual Collective Investment Scheme operators, even though our policy intention is to extend the option to all buy-side firms over time (see 1.14). Regardless of the availability of the proposal to buy-side firms, we expect that all buy-side firms will familiarise themselves with the proposals. We think that the proportion of buy-side firms that take up the option is a reasonable upper bound of likely take-up, regardless of the narrower scope of the proposals.

Summary of Impacts

Table 2: Summary table of benefits and costs

Group affected	Item description	Benefits (£m)		Costs (£m)	
		One off	Annual Ongoing	One off	Annual Ongoing
Buy-side firms	Direct				
	Familiarisation costs			0.37	
	IT, system and process costs			4.93	
	Indirect				
	Lower research procurement costs		Not quantified		
Sell-side firms	Direct:				
	Familiarisation costs			0.27	
	Indirect:				
	IT, system and process costs			3.72	
	Increased research costs			Not quantified	
Investors	Indirect:				
	Potential increase in costs				Not quantified
Total				9.29	

Table 3: Present Value and Net Present Value, £m

	PV Benefits	PV Costs	NPV (10 years) (benefits-costs)
Total impact		9.3	9.3
-of which direct		5.6	5.6
-of which indirect		3.7	3.7
Key unquantified items to consider			Lower research procurement costs Potential increase in research costs for sell-side and higher costs for investors

Table 4: Net direct costs to firms, £m

	Total (Present Value) Net Direct Cost to Business (X yrs)	Equivalent Annual Net Direct Cost to Business
Total net direct cost to business (costs to businesses – benefits to businesses)	5.6	0.6

- 36.** The proposals we are making are optional for asset managers to take up. We would expect that asset managers would only take up the option provided by our proposals where the expected benefits for them would outweigh the costs. The same is true for research providers on the sell-side. They will only change their approach if they believe they will benefit from it. This implies that our proposals are inherently proportionate for these two groups of firms.
- 37.** The remaining likely costs are the potential costs on investors that arise from a reduction in the protections from the principal-agent problems that we previously observed when research was bundled with investment research. Our guardrails are designed to prevent these costs reoccurring. We therefore believe our proposals are net beneficial.

Benefits

More efficient investment research procurement

- 38.** Our proposals provide asset managers the option of combining the cost of research with execution charges. Asset managers will only take up this option when it is in their interests to do, and we believe the final number doing so may be relatively small. For those asset managers that do take up the option, the process of procuring research will be more efficient for them. The reduction in costs that arise will reduce the operational costs to UK asset managers of accessing investment research from other jurisdictions, most obviously the US. This will have a direct effect on the costs of providing asset management services to investors.
- 39.** We do not think it is reasonably practicable to estimate the savings that might emerge from our proposals. Our survey results show that asset managers were unable to meaningfully provide estimates of the costs. We believe that it is likely to equally apply to the benefits and reduction in costs. There is significant uncertainty about the number of firms that will take up our proposals. It is equally unclear how end investors will react to asset managers proposing to take up the option.
- 40.** In addition, there may also be an increase in the amount or breadth of research purchased. There may be some benefits from this as investors gain an enhanced understanding of new sectors, business models and product innovations, which improves investment decision making rather than through investment outperformance in the funds themselves.

Potential effect on competition

- 41.** Bundled payments of research and trade execution may be more scalable to the business models of new entrants and small but fast-growing firms. This is because purchasing research through bundled payments is more likely to scale with the growth of a firm's assets under management. This is because we might expect that trading costs and hence research spend when bundled will grow in similar proportions to assets managed. This provides advantages over the higher fixed costs of building internal research capabilities, paying for research from their own resources (while seeking to invest in growth or achieve profitability), or maintaining more operationally demanding RPAs (including the outlays required to build and maintain these). Overall bundled payments may make it easier for new asset managers to enter and scale their business. There may therefore be some benefits to competition from supporting smaller asset managers growing their business.
- 42.** We note that that our guardrails protect against any risk to competition from bundling that might otherwise emerge. Hence, we do not consider adverse effects on competition from re-bundling of research.

Costs

- 43.** Buy-side firms could choose not to use the new option on how to pay for research, in which case there would be no compliance costs to them. Industry engagement by the FCA indicates that many buy-side firms have limited appetite to change the research procurement processes they recently put in place as a result of MiFID II and many may not make any changes.
- 44.** Sell-side firms may also decide not to offer the new payment option, in which case there would be no compliance costs to them. We expect that sell-side firms will only make these changes where they believe it is profitable for them to do so.

Familiarisation costs

- 45.** There will be one-off familiarisation costs for firms subject to our proposed changes, regardless of whether these choose to offer the new payment option as they will seek to understand the changes. We expect that approximately 800 buy-side firms and all 470 wholesale banks and brokers firms will wish to familiarise themselves with these proposals. We assume that all asset managers incur familiarisation costs regardless of whether they choose to take up the new option. We also assume that all sell-side firms make themselves familiar with the proposals even if they might not all change their approach to selling research.
- 46.** We use the SCM, explained in the 'Key assumptions' section above, to estimate the familiarisation costs for market participants based on assumption on the time required to read the approximately 40 relevant consultation pages excluding the legal instruments. We assume 300 words per page and a reading speed of 100 word per minute and estimate that it would take around 2 hours to read the document. It is further assumed that compliance staff (20 staff at each large firm, 5 staff at each medium firm and 2 staff at each small firm) will read the text.

- 47.** We convert this to a monetary value by applying an estimate of the cost of time to market participants, based on Willis Towers Watson 2022 salary data, including 30% overheads. We assume that the hourly compliance costs (including overheads) are £61, £57 and £47 for large, medium and small firms respectively. We also assume that the CP is reviewed by 20 staff in large firms, 5 in medium firms and 2 in small firms.
- 48.** We do not expect firms to conduct a legal review of the proposals and a gap analysis to check their current practices against expectations as our proposals grant firms a new option, rather than introduce new requirement on firms.
- 49.** Using the above assumptions we estimate total industry-wide familiarisation costs for the 1,300 firms to be approximately £0.64m. We break this down by type and size of firm in the tables below.

Table 5: Estimates of familiarisation costs for buy-side firms

Size of firm	Number of firms	Cost per firm	Total one-off cost for all firms
Small	618	£260	£160,000
Medium	163	£787	£130,000
Large	24	£3,378	£80,000

Table 6: Estimates of familiarisation costs for sell-side firms

Size of firm	Number of firms	Cost per firm	Total one-off cost for all firms
Small	310	£260	£80,000
Medium	139	£787	£110,000
Large	25	£3,378	£80,000

Systems, process and IT costs

- 50.** For those asset managers that do decide to take up our proposals, there may be some costs incurred in the form of additional systems, process and IT costs. As we noted above when describing the number of firms affected, we assume that up to 20% of firms take up the option.
- 51.** We expect that buy-side firms would incur one-off systems, process and IT costs in order to make the necessary changes to their procurement processes to allow them to make use of the bundled payments option. However, we expect that the incremental ongoing costs would be minimal when compared to existing ongoing costs of other options already available (e.g. RPAs).

- 52.** Again, we use our SCM to estimate the one-off systems, process and IT costs for firms. We estimate that the number of single person days to adjust systems would be 546 for a large firm and 156 for a medium and small firm and 50 days of person time to implement the change (across various business types). We use an average daily salary cost of £408, £390 and £291 for large, medium and small firms respectively. This implies a cost of £223k for large firms, £61k for medium firms and £14k for small firms using data on salaries.
- 53.** In total, we expect one-off systems and process and IT costs of £4.9m for those choosing to offer the payment option.

Table 7: Estimates of systems, processes and IT costs for buy-side firms

Size of firm	One-off cost per firm	Number of firms	One-off cost for industry
Small	£14,540	124	£1,800,000
Medium	£60,935	33	£2,010,000
Large	£223,005	5	£1,120,000

- 54.** Sell-side firms would also incur one-off costs when making the necessary changes to their procurement processes. They would need to review their business models to develop charging structures and service agreements with investment firms for the supply of research on a bundled basis. Costs may be lower for any sell-side firms that already offer a bundled service to clients in other jurisdictions (e.g. US).
- 55.** We did not include sell-side firms in our cost survey. However, we think it is reasonable to assume that sell-side firms will incur a similar level of costs to buy-side firms. We note that we used this assumption in CP21/9: "Changes to UK MIFID's conduct and organisational requirements". In this CP we received indicative cost estimates from one large buy-side firm on the costs of setting up systems to ensure that SME research can benefit from the proposed SME exemption. We then used the figure provided by the buy-side firm to estimate the costs for sell-side firms. We did not receive any feedback from stakeholders to suggest that this approach was not suitable.
- 56.** Given this, we assume that sell-side firms incur the same cost as buy-side firms. We provide a breakdown of costs, by size of firm, below.

Table 8: Estimates of systems, processes and IT costs for sell-side firms

Size of firm	One-off cost per firm	Number of firms	One-off cost for industry
Small	£14,540	62	£900,000
Medium	£60,935	28	£1,710,000
Large	£223,005	5	£1,120,000

Increased costs of research

- 57.** Our proposals may increase the amount of investment research spend and the volume of research purchased. However, any increase in the coverage of research would also entail more resources being used at an aggregate level to create this research. We do not consider it reasonably practicable to estimate the increased cost of research (at an aggregate or unit level) as it is difficult to predict take-up of the new option and the subsequent effects on research production and spend. However, in CP21/9, we estimated that there is a one-off starting cost of £15k-30k and an ongoing cost of £9-28k for covering an additional SME firm. Accounting for inflation, these would be £17-34k and £10-38k in 2023 prices for one-off and ongoing cost respectively of increased coverage. We might expect that covering larger firms adds complexity and cost to coverage, but we do not think that the costs will be materially greater than this estimate.

Costs to investors

- 58.** Investors may face additional costs as asset managers shift the cost of research on to them, or the amount of research is increased. This will especially be the case where regulated firms have until now absorbed research costs into their own resources (typically asset managers) rather than charging them to clients via RPAs. Increased costs could also be due to (i) the purchase of unnecessary services, should the guardrails be insufficient preventing buy-side firms from not exercising adequate discipline in passing the costs of low-quality or duplicative research back to investors or (ii) an increase in the price of research due to reduced transparency and competitive pressure.
- 59.** These higher investor costs could be outweighed, in theory, by buy-side firms finding the bundled approach to be net beneficial to the interests of their clients. This is more likely to be the case where the research is high-quality and not duplicative, and there are strong guardrails to prevent over-consumption of research and ensure fair and transparent cost allocation.

Costs to the FCA

- 60.** The FCA will incur supervisory costs in ensuring that firms which do use the proposed bundled payment option are complying with the necessary guardrails. However, we do not expect to use more supervisory resources than under the baseline. Hence, any increase in costs would be of minimal significance.

Wider economic impacts, including on secondary objective

- 61.** We have considered how our proposals advance our Secondary International Competitiveness Growth Objective (SICGO). The drivers are operational efficiency, proportionate regulation, trust and reputation, innovation, effective competition, market stability, and international markets. We consider that proportionate regulation, international markets and competition are the most relevant drivers to our proposals, and we discuss these below.

- 62.** The key objective of our proposals is to provide asset managers with flexibility in the way that they pay for their research and efficiency in obtaining research. Our research found that there are barriers to obtaining research for some UK asset managers from the current regulatory structure. Our proposals will therefore help to reduce the costs of regulation for asset managers and help make regulation more proportionate.
- 63.** Any reduction in the cost of regulations, and consequently the price of asset management, for UK asset managers will increase the attractiveness of the UK asset management industry.
- 64.** The extra flexibility afforded to asset managers under a new payment option for investment research could mean that they have greater control over how to pay for investment research and their costs become more scalable, i.e., they could choose a payment option that is better tailored towards their size and business models. If the payment option is used appropriately, this would in turn mean that investors may be able to benefit from greater competition amongst asset managers, because the flexibility in payment may be able to better facilitate new asset managers entering the market.

Monitoring and evaluation

- 65.** We would measure take-up of the new option by a firm survey or further multi-firm review supervisory work. In this survey, we would also seek to understand whether there were costs savings or similar benefits from taking up the option.

Question 12: Do you have any comments on our cost benefit analysis?

Question 13: 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.

Annex 3

Compatibility statement

Compliance with legal requirements

1. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this consultation, including an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under the Financial Services and Markets Act 2000 (FSMA).
2. When consulting on new rules, the FCA is required by section 138I(2)(d) FSMA to include an explanation of why it believes making the proposed rules (a) is compatible with its general duty, under section 1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with its strategic objective and advances one or more of its operational objectives, (b) so far as reasonably possible, advances the secondary international competitiveness and growth objective, under section 1B(4A) FSMA, and (c) complies with its general duty under section 1B(5)(a) FSMA to have regard to the regulatory principles in section 3B FSMA. The FCA is also required by s 138K(2) FSMA to state its opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.
3. This Annex also sets out the FCA's view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (section 1B(4)). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.
4. In addition, this Annex explains how we have considered the recommendations made by the Treasury under s 1JA FSMA about aspects of the economic policy of His Majesty's Government to which we should have regard in connection with our general duties.
5. This Annex includes our assessment of the equality and diversity implications of these proposals.
6. Under the Legislative and Regulatory Reform Act 2006 (LRRRA) the FCA is subject to requirements to have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions like making rules). This Annex sets out how we have complied with requirements under the LRRRA.

The FCA's objectives and regulatory principles: Compatibility statement

7. The proposals set out in this consultation are primarily intended to advance the FCA's objective of promoting effective competition in the interests of consumers, as detailed in Chapter 2. The introduction of a new option is intended to make the process of procuring research less complex, less resource-intensive and more scalable for smaller, faster-growing and new entrant asset managers currently using RPAs. The changes proposed should consequently advance this objective by improving the ease with which asset managers can enter the asset management market. This would in turn mean that investors are able to benefit from greater competition amongst asset managers.
8. We consider these proposals are also compatible with the FCA's objective of securing an appropriate degree of protection for consumers. The guardrails we are proposing around firms' use of the proposed option should ensure our competition and market integrity objectives are advanced without undue costs or harms to consumers.
9. We consider these proposals comply with the FCA's secondary objective in advancing competitiveness and growth. This is because they seek to provide, where possible, alignment with the procurement rules of other jurisdictions for investment research. This should enable UK asset managers to better compete on a global basis. A competitive asset management industry should also support the contribution of the financial services sector to the UK economy as a whole.
10. We have concluded that these proposals should have a neutral or marginally positive impact on our market integrity objective, but with a lesser evidence base. For the purposes of the FCA's strategic objective, "relevant markets" are defined by section 1F FSMA.
11. In preparing the proposals set out in this consultation, the FCA has had regard to the regulatory principles set out in s 3B FSMA.

The need to use our resources in the most efficient and economic way

12. Our proposals are designed to be as proportionate as possible relative to risk, and ensure that firms and clients have clarity about our expectations.

The principle that a burden or restriction should be proportionate to the benefits

13. The CBA in Annex 2 sets out the costs and benefits of the proposals in the CP. We believe that the benefits of these proposals outweigh the costs.

The need to contribute towards achieving compliance by the Secretary of State with section 1 of the Climate Change Act 2008 (UK net zero emissions target) and section 5 of the Environment Act 2021 (environmental targets)

14. This principle is not relevant to our proposals.

The general principle that consumers should take responsibility for their decisions

15. We have had regard to this principle including consideration of proportionate requirements on reporting and disclosure according to the level of knowledge and experience of different types of clients.

The responsibilities of senior management

16. Our proposals do not specifically relate to the responsibilities of senior management. Nevertheless, we have had regard to this principle and do not consider that our proposals undermine it.

The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons including mutual societies and other kinds of business organisation

17. We consider that our proposals do not undermine this principle. We have had regard to the wide range of providers and users of investment research – including asset managers, brokers and IRPs – with the aim of proposing an appropriate and proportionate new payment option.

The desirability of publishing information relating to persons subject to requirements imposed under FSMA, or requiring them to publish information

18. This principle is not relevant to our proposals.

The principle that we should exercise of our functions as transparently as possible

19. By explaining the rationale for each of our recommendations and the anticipated outcomes, the FCA has regard to this principle.
20. We do not regard our proposals as being relevant to the need for the FCA to have regard to the importance of taking action intended to minimise the extent to which it is possible for a business carried on (i) by an authorised person or a recognised investment exchange; or (ii) in contravention of the general prohibition, to be used for a purpose connected with financial crime (as required by s 1B(5)(b) FSMA).

Expected effect on mutual societies

- 21.** The FCA does expect the proposals in this paper to have a significantly different impact on mutual societies. The relevant rules we propose to amend will apply, according to the powers exercised and to whom they are addressed, equally regardless of whether it is a mutual society or another authorised body.

Compatibility with the duty to promote effective competition in the interests of consumers

- 22.** In preparing the proposals as set out in this consultation, we have had regard to the FCA's duty to promote effective competition in the interests of consumers. Competition issues are discussed in our analysis of our proposals on research.

Equality and diversity

- 23.** We are required under the Equality Act 2010 in exercising our functions to 'have due regard' to the need to eliminate discrimination, harassment, victimisation and any other conduct prohibited by or under the Act, advance equality of opportunity between persons who share a relevant protected characteristic and those who do not, to and foster good relations between people who share a protected characteristic and those who do not.
- 24.** As part of this, we ensure the equality and diversity implications of any new policy proposals are considered. The outcome of our consideration in relation to these matters in this case is stated in paragraph 2.36-2.38 of the Consultation Paper.

Legislative and Regulatory Reform Act 2006 (LRRRA)

- 25.** We have had regard to the principles in the LRRRA for the parts of the proposals that consist of general policies, principles or guidance relating to the new proposed rules on the payment optionality model for investment research services. We consider that these parts of the proposals have had regard to the five LRRRA principles – that regulatory activities should be carried out in a way which is transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed.
- 26.** We have had regard to the Regulators' Code for the parts of the proposals that consist of general policies, principles or guidance and consider that the new guidance being proposed is intended to support the clarity and interpretation of the proposed rules.

Annex 4

Guardrail features in our survey

- 1.** A “no free-rider guardrail”, requiring that a firm ensures that all relevant clients’ dealing commissions are used (i.e. individual clients would not be permitted to contract out of commission payments for research).
- 2.** A “strategy-specific guardrail”, requiring that a firm ensures that a client pays only for research directly and materially relevant to the investment strategy in which it is invested.
- 3.** A “procurement guardrail”, requiring minimum standards when choosing research providers and agreeing prices for goods and services, whenever clients’ dealing commissions are used.
- 4.** A “research budget guardrail”, requiring firms to set ex ante research budgets for periods not exceeding twelve months, at investment strategy level, and to cut commissions to pre-agreed execution-only rates for the remainder of the period, once research expenditure has reached such budget.
- 5.** A “disclosure guardrail”, requiring the firm to provide periodic disclosures to clients describing the nature of research purchased at investment strategy level and narratives describing the impact of research at strategy level on investment outcomes during each period.
- 6.** An “all-in fee basis points disclosure guardrail”, requiring firms to disclose to prospective and existing clients, fee scales at strategy level that include both investment management fees and research payments using dealing commissions for the prior 12 months, expressed as a proportion of average assets under management for the strategy during the prior 12 months.
- 7.** A “counterparty guardrail”, requiring that the portion of execution costs that can be used by the firm to purchase research is, with a set frequency (e.g. monthly), transferred into a bank account controlled by the firm.

Annex 5

Abbreviations in this document

Abbreviation	Description
CBA	Cost Benefit Analysis
COBS	Conduct of Business sourcebook
CP	Consultation Paper
CSA	Commission Sharing Arrangement
ESG	Environmental Social and Governance
ESMA	European Securities and Markets Authority
EU	European Union
FCA	Financial Conduct Authority
FICC	Fixed Income Currencies and Commodities
FSMA	Financial Services and Markets Act 2000
IRR	Investment Research Review
IRP	Independent Research Provider
LSE	London Stock Exchange
MiFID	Markets in Financial Instruments Directive
MiFID II	Markets in Financial Instruments Directive II
NAL	No Action Letter
P&L	Profit and Loss
PS	Policy Statement
RPA	Research Payment Account
SCM	Standardised Cost Model

Abbreviation	Description
SEC	Securities and Exchange Commission
SICGO	Secondary International Competitiveness and Growth Objective
SME	Small and Medium Enterprise
UK	United Kingdom
US	United States
WMR	Wholesale Markets Review

Disclaimer

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

We are obliged to list the names of respondents, which is a matter separate from any request for the content of a response to be kept confidential. However, we will only publish the name of a respondent to a consultation where that respondent has consented to the publication of their name.

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Appendix 1

Draft Handbook text

PAYMENT OPTIONALITY (INVESTMENT RESEARCH) INSTRUMENT 2024

Powers exercised

- A. The Financial Conduct Authority (“the FCA”) makes this instrument in the exercise of the powers and related provisions in or under the following sections of the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137A (The FCA’s general rules);
 - (2) section 137T (General supplementary powers); and
 - (3) section 139A (Power of the FCA to give guidance).
- B. The rule-making powers listed above are specified for the purposes of section 138G(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on [*date*].

Amendments to the Handbook

- D. The Conduct of Business sourcebook (COBS) is amended in accordance with the Annex to this instrument.

Citation

- E. This instrument may be cited as the Payment Optionality (Investment Research) Instrument 2024.

By order of the Board
[*date*]

Annex

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

2 Conduct of business obligations

...

2.3A Inducements relating to MiFID, equivalent third country or optional exemption business and insurance-based investment products

...

Acceptable minor non-monetary benefits

2.3A.19 R An acceptable minor non-monetary benefit is one which:

...

(5) consists of:

...

(g) ~~research on listed or unlisted companies with a market capitalisation below £200m, provided that it is offered on a rebundled basis or provided for free. The market capitalisation is to be calculated with reference to the average closing price of the *shares* of the company at the end of each *month* to 31 October for the preceding 24 *months*. For companies newly admitted to trading, determination of the threshold should be based on the market capitalisation at the close of day one trading and apply until the date of the next re-assessment (i.e. 31 October). For these purposes, *firms* may reasonably rely on the assessment of a third party that the research is on a company with a market capitalisation below £200m; [deleted]~~

...

(j) written material that is made openly available from a third party to any firm wishing to receive it or to the general public. “Openly available” in this context means that there are no conditions or barriers to accessing the written material other than those which are necessary to comply with relevant regulatory obligations, for example requiring a log-in, sign-up or submission of user information by a firm or a member of the public in order to access that material; ~~or~~

- (k) *corporate access services* which relate to listed or unlisted companies with a market capitalisation below £200m ~~in accordance with COBS 2.3A.19R5(g)~~; or
- (l) short-term trading commentary that does not contain substantive analysis, and bespoke trade advisory services intrinsically linked to the execution of a transaction in financial instruments.

...

...

2.3B Inducements and research

...

Receiving third party research without it constituting an inducement

2.3B.3 R Third party *research* that is received by a *firm* providing *investment services* or *ancillary services* to *clients* will not be an inducement under *COBS 2.3A.5R*, *COBS 2.3A.15R* or *COBS 2.3A.16R* if it is received in return for ~~either~~ one of the following:

- (1) direct payments by the *firm* out of its own resources; ~~or~~
- (2) payments from a separate *research* payment account controlled by the *firm*, provided that the *firm* meets the requirements in *COBS 2.3B.4R* relating to the operation of the account; or
- (3) joint payments for third-party *research* and execution services, provided that the *firm* meets the requirements in *COBS 2.3B.25R* to *2.3B.31R* relating to the operation of such joint payments.

...

...

Research for the purposes of research payment accounts and joint payments for research and execution services

2.3B.21 R A *firm* must only use monies in a *research* payment account established under *COBS 2.3B.3R(2)* to pay for *research* or to pay a rebate to *clients* in accordance with *COBS 2.3B.8R(3)(a)*, ~~and must use the separately identifiable *research* charge of joint payments for *research* and execution services under *COBS 2.3B.3R(3)* only to pay for *research*.~~

...

2.3B.23 G Examples of goods or services that the *FCA* does not regard as *research*, and as a result could not be paid for from *research* payment accounts or joint

payments for research and execution services, include:

...

(10) direct money payments; and

(11) administration of a research payment account; and

(12) administration of:

(a) an account for joint payments for research and execution services; or

(b) a research provider payment allocation structure.

2.3B.24 G A firm should not enter into any arrangements relating to the receipt of, and payment for, third party *research*, whether acquired in accordance with COBS 2.3B.3R(1) ~~or (2), (2) or (3)~~, that would compromise its ability to meet its best execution obligations as applicable under COBS 11.2A.

2.3B.25 R The requirements referred to in COBS 2.3B.3R(3) for the operation of joint payments for third-party research and execution services are:

(1) the firm must have a formal policy on joint payments that:

(a) describes the firm's approach to joint payments, and how the firm will ensure compliance with the requirements in COBS 2.3B.25R(2) to COBS 2.3B.31R; and

(b) specifies how the firm's governance, decision-making and controls in respect of third-party research purchased using joint payments operate, including how these are maintained separately from those for trade execution;

(2) the firm must enter into written agreements with research and execution service providers which establish a methodology for how the research costs will be calculated and identified separately within total charges for such joint payments;

(3) the firm must have a research provider payment allocation structure for the allocation of payments between different research providers, including:

(a) third-party providers of research and execution services; and

(b) research providers not engaged in execution services and not part of a financial services group that includes an investment firm which offers execution or brokerage services;

(4) the firm is fully responsible for:

(a) the administration of accounts for purchasing research from

joint payments;

(b) ensuring the operation of such accounts do not interfere with the compliance of the *firm*'s obligations under this chapter; and

(c) ensuring timely payments to *research* providers;

(5) the *firm* must set a budget for the purchase of *research* using joint payments:

(a) based on the expected amount needed for third-party *research* in respect of *investment services* rendered to its *clients*, and not linked to the expected volumes or values of transactions executed on behalf of *clients*;

(b) at least annually and at an appropriately aggregated level (eg, for similar investment strategies or groups of *clients* who would benefit from the same *research*);

(6) the *firm* must allocate the costs of *research* purchased using joint payments fairly between *clients*;

(7) the *firm* must periodically, but at least annually:

(a) assess the value, quality and use of *research* purchased using joint payments and its contribution to the investment decision-making process; and

(b) undertake benchmarking of prices paid for *research* services purchased using joint payments against relevant comparators, to ensure the amount of *research* charges to *clients* are reasonable compared to those for comparable services; and

(8) the *firm* must disclose to its *clients* the items listed in COBS 2.3B.30R.

2.3B.26 R If the amount of *research* charges to *clients* exceeds the budget set out under COBS 2.3B.25R(5), or the budget is increased, the *firm*'s policy must set out:

(1) the relevant actions to be taken in such circumstances; and

(2) the information to be disclosed to *clients*.

2.3B.27 G For the purposes of cost allocation under COBS 2.3B.25R(6), the *firm* should determine a cost allocation level appropriate to its business model. The specific cost of individual investment *research* items need not be discretely attributable to individual *clients*. The approach should be reasonable and its outcome fair across all *clients*, such that relative costs incurred are commensurate with relative benefits received. This includes across *clients* with which the *firm* has different payment arrangements for the purchase of *research*, across *clients* that are managed according to similar investment strategies, and across different *clients* or groups of *clients* that benefit from the

same research.

- 2.3B.28 R Where a firm delegates the administration of a research provider payment allocation structure or joint payments research account, it retains responsibility for complying with the requirements for its administration under this chapter. The firm must ensure that the reconciliation and reporting for such accounts and structures is undertaken with an appropriate frequency and timeliness, and continue to monitor and manage risks from unspent surplus amounts and research provider concentrations of these.
- 2.3B.29 R Research services must not be treated as an execution factor under COBS 11.2A.2R.
- 2.3B.30 R For the purposes of the disclosures in COBS 2.3B.25R(8), the firm must disclose to relevant clients:
- (1) the firm's use of joint payments for research, including, where relevant, how the use of joint payments is combined with the use of other payments permitted under COBS 2.3B.3R;
 - (2) the key features of the firm's policy on joint payments in COBS 2.3B.25R(1), or the policy itself, having regard to the information needs of its clients. This information must be communicated to them in a way which is clear, fair and not misleading;
 - (3) the expected annual costs to the client, provided as part of ex ante disclosures on costs and charges, and based on both:
 - (a) the budget-setting and cost allocation procedures set out in COBS 2.3B.25R(5), COBS 2.3B.25R(6) and COBS 2.3B.27G; and
 - (b) the actual costs for prior annual periods disclosed under COBS 2.3B.30(5);
 - (4) the most significant research providers (measured by total amounts paid), and the benefits and services received from such providers, at an appropriate level of aggregation relevant to that client (eg, for similar investment strategies or groups of clients who benefit from the same research);
 - (5) the total costs incurred by the client, disclosed on an annual basis, reflecting the total payments made for research purchased using joint payments over that period, and provided as part of ex post reporting on costs and charges; and
 - (6) where relevant, the disclosures set out in COBS 2.3B.26R.
- 2.3B.31 R For the purposes of the disclosures in COBS 2.3B.25R(8), firms must make the disclosures in:

- (1) COBS 2.3B.30R(1) to (4) before providing an *investment service* or *ancillary service*, and thereafter upon request, but at least annually;
- (2) COBS 2.3B.30R(5) as part of the *firm's* costs and charges disclosures, separately identifying joint payment *research* charges in such disclosures; and
- (3) COBS 2.3B.30R(6) in accordance with the budget period set in COBS 2.3B.25R(5).

