

UK Investment Research Review – UKEMA response to the Call For Evidence

The UKEMA welcomes the opportunity to respond to the “UK Investment Research – Call for Evidence”. The UKEMA represents those investment banks and equity brokerage firms that focus on raising capital for SMEs and small and mid-cap quoted companies. Its members trade in the shares of over 2,000 quoted companies, accounting for 57% of London Stock Exchange turnover by volume, and produce research on over 1,700 companies, representing 87% of listed issuers. UKEMA member firms facilitated investment of more than raised £6.7bn in funds for companies in 2021, supporting growth in the real economy, employment, innovation, entrepreneurship and wealth creation.

We note the background to the Review and its purpose which is to examine the link between levels of research and the attractiveness of the UK capital markets for companies seeking access to capital. As UK investment banks representing small and mid-cap quoted companies our members are uniquely placed to comment on these topics. We have answered each of your questions below to the extent that our members have views, however, in this part of our response we wish to set out our views on some key themes in relation to UK investment research.

Key Themes

Importance of research

Our members strongly believe that research plays an important role in the UK capital markets ecosystem. In the recent past, the quality and breadth of research has declined, in particular for small and mid-cap companies. Most research is also limited to institutional investors and our members believe that it would be beneficial if the regulatory framework was more conducive to permitting the sharing of research with retail investors. However, members also note that creating a better environment for research is only one factor in the success of the UK capital markets and that a holistic approach to the issues facing UK capital markets is needed.

Retail access to research

Our members ask the Review to consider whether the legal and regulatory framework might be changed to incentivise financial institutions to provide research to retail investors. A specific regime creating parameters for the production of retail research which, if followed, provided financial institutions with protection from legal liability would be welcomed and our members believe it would benefit the market as a whole. We appreciate this is a complex area. However, retail investors are currently disadvantaged and discouraged from investing in listed securities (particularly at IPO stage) because, unlike institutional investors, for the most part they are unable to receive impartial and informed opinions about issuers, instead they are left to seek opinions from the media, web chatrooms, podcasts and social media. Along with increased access to primary capital markets transactions, giving retail investors access to investment research should be viewed as part of the levelling of the playing field (with institutional investors) agenda and would in fact help to offset some of the concerns of having retail investors investing in a more meaningful way in UK plc. They would be investing on a more informed basis.

Smaller companies

The production of research for smaller companies is not always economically viable. These companies will typically have little liquidity and therefore there will not be sufficient demand to buy the research. It is a vicious circle as without research there is less opportunity to increase liquidity. One way of breaking this cycle would be to encourage more issuers to pay analysts for sponsored research. Our members have flagged the French charter on sponsored research and the EU presidency consultation in this regard, which suggest that this approach is becoming more attractive in other jurisdictions. There is a perception in the UK that sponsored research is not impartial or balanced, but this would not be the case if it became more commonplace, whether through regulatory change to mandate research or through stakeholders actively promoting the option of sponsored research. It is important, however, that sponsored research encourages investors to trade in the securities. In the UK, sponsored research tends to be factual in nature and does not include a recommendation. The Review should consider whether the regulatory regime (including the rules around inducements) needs to be amended to encourage and support sponsored research cognisant that it would have to be managed within conflicts of interest restrictions.

Pricing and sale of research

Members note the proposals in the joint response to the Call for Evidence from UK Finance and AFME and, in particular, the proposal to allow broader optionality for research payments to allow clients how they consume research (i.e., either bundled or unbundled). Our members are in favour of such optionality, and believe that more choice for consumers may well increase demand for research. Our members do note, however, that they would not be in favour of any change to the bundling requirements that required them to incur material further expense and operational change to comply with a completely new approach. Members would appreciate early consultation on any proposed changes to avoid unnecessary consequences which could have a further detrimental effect.

Our members also note that restrictions on sale of research as a result of the inducements regime has been unhelpful in increasing demand for research. In particular, the restriction on selling research to funds for twelve months following a free trial often means that our members cannot offer research to different teams within the same investment fund within a 12 month period even where there may be a demand. Our members believe the rules on selling research should be fully reviewed.

Q1. How does investment research provision in the UK compare, or how is it perceived to compare, with other major international financial services centres?

UKEMA focuses on UK markets and therefore does not have as much visibility on other markets as other respondents may have. We would, however, draw the Review's attention to the proposal in France mentioned above to encourage the concept of sponsored research.

Q2. What is your assessment of the amount, quality and type of investment research currently provided on companies that are listed or quoted, or seeking to be listed or quoted, on the UK public markets?

- ***Has that position changed since 2014 (when the UK took steps regarding the use of dealing commission) (or earlier) or 2018 (when the MiFID II unbundling rules came into effect)?***
- ***If you are aware of particular differences relating to specific sectors (e.g. technology and/or life sciences), please provide further details.***
- ***If you are aware of particular differences with other jurisdictions, please provide further details.***

The amount of research coverage of AIM and smaller listed companies has declined. A study conducted by the European Securities and Markets Authority in 2017-2019 found that smaller companies have experienced a decline in research coverage since the implementation of MiFID II¹. The study found that the number of research reports on small and mid-cap companies declined by 19% in the first year after MiFID II was implemented. Similarly, a survey conducted by the CFA Institute in 2019 found that the unbundling of research fees has led to a decrease in research coverage for small and mid-cap companies². Quality has deteriorated; as there are fewer analysts there is less competitive pressure.

In relation to AIM, there has been some growth in corporate-sponsored 'research' paid for by the AIM-admitted company. This type of research tends to be factual in nature, offering no opinion or recommendation and does not encourage investors to trade in the market.

Q3 How important is investment research to the attractiveness of the UK public markets to listed companies (or companies considering listing) and their investors or to companies looking to access capital in private markets?

As referenced above, investment research is enormously important to companies and their investors. Research provides information on corporates and their sectors, opinions on both and calls to action (buy or sell recommendations), producing a better-informed and more active investor base, resulting in greater liquidity and enhanced price formation, to the benefit of both listed companies and their investors.

Is there a specific link between research and valuations for listed companies or those seeking to list?

Research is critical to potential investors' valuations of companies admitted to trading or seeking admission to trading. In the latter case, it would be impossible to persuade institutional investors to support an IPO without at least one analyst producing pre-IPO research and the same logic applies to retail investors whose participation is being increasingly both encouraged and, through changes to regulation, facilitated. See above for comments on research and valuation (price formation) for companies already admitted to trading.

Q4 Are there specific issues relevant to UK investment research on technology and life sciences companies that should be addressed, including compared to other jurisdictions?

¹ https://www.esma.europa.eu/sites/default/files/trv_2020_2-mifid-ii_research_unbundling_first_evidence.pdf

² <https://blogs.cfainstitute.org/marketintegrity/2019/03/20/mifid-ii-research-unbundling-a-survey-yielding-mixed-results/>

No comment.

Q5 Are there specific issues relevant to UK investment research on smaller UK listed or quoted companies that should be addressed?

Yes. In addition to the economic viability of producing research for smaller less liquid companies referenced above, trading in smaller UK quoted companies is dominated by retail investors. As set out above, research produces a better-informed and more active investor base, resulting in greater liquidity and enhanced price formation, to the benefit of both listed companies and their investors. The current UK rules governing production and distribution of investment research, however, make it difficult and expensive (both in terms of costs incurred and risks assumed), to produce and distribute research to retail investors.

Please see above for further comments and suggestions relating to research aimed at retail investors.

Q6 What demand do investors have for research on UK listed and quoted companies, what are the factors driving this demand, and is the amount, quality and type of investment research currently provided sufficient to meet this demand?

There is significant investor demand for research on UK listed and quoted companies, both from retail investors, who dominate trading in the AIM secondary market (by number of trades) and institutions, which tend to dominate investment in IPOs and secondary fundraises. The factors driving demand for research from both types of investor are essentially the same: the need for factual information on a company, a view of its valuation, opinions as to the prospects of the company and its sector and a trading recommendation (i.e. Buy/Sell/Hold).

The amount, quality and type of investment research currently provided is not sufficient to meet this demand. Please see Q.2, above, for more detailed comments on this point.

Q7 What impact does the current UK legislative and regulatory environment have on the provision and quality of research, including (but not limited to) the MiFID II unbundling rules? Please provide references to relevant legislative/regulatory provisions with your answer where relevant.

The unbundling rules, combined with the FCA's continued pressure on asset managers to cut the amount of commission paid out of their clients' funds, has resulted in significantly lower commission income for brokers, reducing the amount of money available to support production of investment research. In addition FCA rules and guidance relating to the production and distribution of investment research make it difficult and expensive (both in terms of costs incurred and risks assumed), to produce and distribute research to retail investors. Please see above for our views on research aimed at retail investors.

Members do not believe COBS 11A or COBS 12.2.21A have been beneficial to investors and have (i) been unhelpful to IPO candidates who previously valued early conversations with analysts to determine the viability of an IPO and (ii) added additional execution risk to IPO by adding seven days to the public phase of the IPO process.

Banks already have in place conflict of interest provisions that govern communications between research analysts and issuers, which banks will apply when analysts engage with companies. COBS 12.2.21A creates uncertainty and has led to fewer conversations between research analysts and potential IPO candidates for fear of ruling the bank out of a role as bookrunner on an IPO. Whilst it is helpful to protect research analysts to have in place clear rules that discourage companies from putting undue pressure on an analyst, the current rules are too rigid and need to be reconsidered.

With regard to COBS 11A, the rules to provide unconnected analysts with the same information as connected analysts in order to write pre-IPO research have not resulted in any perceptible change to the amount of unconnected research. In addition, they present companies with significant extra costs and mandate an additional week to the IPO timetable which increases execution risk.

Q8 Have the UK 2022 revisions to the MiFID unbundling rules applicable to smaller quoted companies helped to facilitate investment research in relation to those companies?

Have these revisions made it more likely that research firms will undertake research on smaller quoted companies?

No. Firstly, the unbundling rules are now embedded in all market participants' processes and systems and, secondly (and more importantly) FCA continues to push asset managers to cut the amount of commission paid to brokers out of their clients' funds. In this environment it is hard to imagine how or why investment managers might attempt to increase the commission rates that their clients' funds pay to stockbrokers.

Is the £200 million market capitalisation threshold appropriate? If not, do you think that a size threshold is the most appropriate tool to incentivise research in smaller companies? If so, what should the level of the threshold be?

Members would be supportive of the optionality for research payments proposed by UK Finance and AFME in their joint submission. If such an approach was adopted, it would be unnecessary to set a threshold.

There are some practical issues with setting a threshold. For example, analysts commonly write on sectors and may include analysis of more than one company in a research report. Market capitalisations do move and it is entirely possible that a company would be above the threshold one month and below it the next.

For UK firms also operating in the EU, does divergence between UK/EU thresholds have an impact (for example affecting where they decide to do business)?

No comment.

Q9 What might be the impact of any changes on the proposed UK legislative and regulatory environment on the provision and quality of research, the management of conflicts and payment for the provision of research?

Please see above regarding our views on reversing the unbundling rules and removing the FCA changes to COBS 11A and COBS 12.2.21A.

Q10 Are there impediments (actual or perceived) to dialogue between UK listed or quoted companies and investment analysts that impinge the quality of research that should be considered and addressed?

Please see comments above in relation to pre-IPO research.

Q11 Are there other impediments (actual or perceived) on the provision of research to investors – whether institutional or private – that should be considered and addressed?

Please see our comments above in relation to provision of research to retail investors.

Q12 What steps (legislative and non-legislative) could be taken to improve the provision and quality of research on UK listed and quoted companies?

Please identify any advantages/ disadvantages and overall impact associated with any step you suggest

Please see our introductory comments.