Introducing payment optionality for investment research services

Introduction

About TheCityUK

TheCityUK is the industry-led body representing UK-based financial and related professional services (FRPS). We champion and support the success of the ecosystem, and thereby our members, promoting policies in the UK, across Europe and internationally that drive competitiveness, support job creation and enable long-term economic growth. The industry contributes over 12% of the UK's total economic output and employs nearly 2.5 million people, with two-thirds of these jobs outside London, across the country's regions and nations. It is the UK's largest net exporting industry and generates a trade surplus exceeding that of all other net exporting industries combined. It is also the largest taxpayer and makes a real difference to people in their daily lives, helping them save for the future, buy a home, invest in a business and protect and manage risk.

TheCityUK's Capital Markets Group brings together a broad range of experts from across the capital markets and listing ecosystem and interested parties, with senior practitioners from the buy side, sell side, intermediaries, and industry bodies. The group brings together these voices to reflect the cross-industry nature of the FRPS industry's role in this ecosystem.

Introducing additional payment optionality for investment research

Overview

The second Markets in Financial Instruments Directive (MiFID II) requires asset managers to charge separate fees for trade execution and for investment research ("**research**"), thereby 'unbundling' them. There is a general acceptance that the MiFID II unbundling requirements have had some adverse impacts on the provision of research and that not all of their anticipated benefits have been achieved. Research supports investor confidence and, therefore, supports the trading liquidity of stocks. The UK's equities research base has been reduced since the introduction of MiFID II[1]. This has affected the size of capital pools willing to invest in UK listed companies and has contributed to a reduction in liquidity as well as, for some stocks, a disparity between the UK and US[2].

[1] The Investment Research Review (IRR) notes that the quality and availability of investment research has fallen on account of the decision of many asset managers to pay for external research from their own resources (the P&L model) - a knock on effect of MIFID II, although the IRR also acknowledges that it is inconclusive whether such a change is solely as a result of MiFID II.

[2] There is market wide acknowledgement that the UK is facing a 'de-equitization' of its markets and a lack of liquidity. This this most acute for companies below FTSE100 (and on the AIM). While liquidity is less visible for the UK markets than, for example, markets where a consolidated tape exists like the US. However, the disparity in liquidity between the UK and the US for some stock had been demonstrated in regular reporting. See for example Financial Times (March 2023) *There are no domestic equity investors': why companies are fleeing London's stock market* illustrates that trading in Ferguson shares leapt after switching to a US listing.

The Investment Research Review (IRR), led by Rachel Kent, recommended that the Financial Conduct Authority (FCA) remove the restriction on combining the cost of research with execution charges, thereby allowing firms to choose how they pay for research. The government accepted all the recommendations made by the review in the Chancellor's 2023 Mansion House speech. This includes a call for the FCA to implement additional payment optionality 'as soon as practicable'.

TheCityUK supports the reintroduction of payment optionality for research, and we call upon the FCA to implement this change as soon as feasible. This paper provides a cross-industry perspective on why this is an important step in increasing the competitiveness of the UK's capital markets, and how the FCA should approach this reform to ensure that any benefits to one part of the industry do not come at the expense of another.

It is our view that the optimal regime would be one where the asset manager has the freedom to make informed decisions to determine the best method of payment (see under 'Introducing additional payment optionality').

To achieve this:

1. The FCA should, as soon as possible, remove the existing rules that prohibit the bundling of research and execution fees to allow additional optionality for paying for such research.
2. If the FCA does not quickly move to enable additional payment optionality for research, the UK regulatory framework for research risks falling behind other jurisdictions, putting UK firms at a competitive disadvantage to those operating overseas, in particular the US and EU. Keeping in mind the FCA's new secondary competitiveness objective, the UK regime should not be more restrictive or inflexible than other jurisdictions.
3. It is vital that the UK treatment of research is tailored to the needs of the UK's unique listing ecosystem, where over 80% of companies by number have a market capitalisation of below £1bn[3]. These smaller cap companies are more likely to be poorly researched and have been disproportionately affected by the overall reduction in the amount of research available. This has direct consequences on liquidity and UK competitiveness.
4. The FCA should carefully consider the practicalities of any new requirements to ensure that they do not lead to non-implementation. Any new rules should not include onerous or complex reporting requirements.

Optionality will allow firms to select the commercial model to consume UK research which is best suited to their needs whether this is driven by their market business model, investment focus, end-investor needs, scale and budget, or home jurisdiction's regulatory framework.

[3] London Stock Exchange (LSE) data shows that, as of December 2023, across the are Main Market and AIM there are 1473 companies in the £0-1bn categories from a total of 1810 companies. ie: 81% of companies by number have a market cap between £0 and £1bn. Taken from: LSE (2023) MAIN MARKET FACTSHEET DECEMBER 2023 and AIM FACTSHEET DECEMBER 2023

Optionality could result in research budget flexibility which could result in increased access and scope, allowing for improvements in the quality and coverage of investment research. This could, in turn, benefit companies (especially small-to-mid cap companies which have relatively less coverage under the status quo), investors who have access to a wider range of investment research on which to base investment decisions and, ultimately, research providers.

As set out in the IRR, the introduction of payment optionality would also remove barriers to UK buy-side firms procuring research from elsewhere in the world where payment on a bundled basis is standard practice, especially the US. The EU has already announced its intention to move away from the current MiFID II approach and allow payment optionality to give greater flexibility to fund managers to remunerate research. The US generally restricts the receipt of special compensation (i.e. unbundled payments) for research unless the research provider is registered as an Investment Advisor. There is a view that the bundled payment model has contributed to US investment banks and brokers being able to invest more in developing research capabilities than in the UK and to maintain broader coverage. The introduction of payment optionality for research would keep the UK aligned with other key jurisdictions, minimising operational complexities and costs, and avoiding being at a competitive disadvantage.

Can bundling be reconciled with best execution without changing the rules?

It should not be necessary to revisit rules on best execution. Best execution rules were in place prior to the introduction of MiFID II research rules and as such a change to those rules to allow payment flexibility should not be required. UK best execution rules have only ever applied to execution and not to other services provided, and so it has never been permissible to consider research services as a factor in assessing best execution. Historically firms had to be satisfied that a broker was providing best execution in order to trade with them, regardless of whether the broker was also providing research services. Having best execution rules is an important protection for clients and removing this safeguard would clearly not be in clients' best interests. As well as being unnecessary and unhelpful, it would also likely make asset owners more hostile to the idea of payment optionality.

The use of Commission Sharing Agreements (CSAs) can facilitate payment optionality and transparency in equities.

The optimal regime would be one where the asset manager has the freedom to determine the method of payment for research that is in the best interests of their clients and reflects the market in which they operate.

In the equities space, **CSAs are one example of a suitable mechanism to bring transparency and flexibility to alleviate this conflict.** A CSA mechanism would also bring the UK model into alignment with other jurisdictions; CSAs were in operation in the UK and Europe prior to MiFID II and continue to be used in the US and the Asia–Pacific region.

How should costs be allocated?

Any new rules should acknowledge that **not every item of research needs to specifically benefit each client contributing to its costs**. Research received by an asset manager is often of general benefit to the firm's clients but it may not be possible to identify which individual research note had benefitted which client.

A degree of flexibility in any mechanism of cost allocation is needed to ensure that firms have sufficiently wide coverage to provide desired content and service to suit a client's needs when they need it. This is important in the context of ever-changing market dynamics and growth.

Should there be limits on amounts paid for research?

There should be no prescribed limit, but should instead be allowed to be develop according to market forces. The budget setting process was a positive impact of unbundling. There should be an obligation on firms to maintain a robust valuation, budgeting and allocation process, including regular assessment of the quality of research.

Asset managers should continue to set transparent annual budgets for research, and evidence robust control mechanisms for the requirements and potential spend of client commissions to pay for research. Firms always have an obligation to act in their clients' best interests, regardless of the level of their total research budget.

However, if firms are prohibited from exceeding a cap they have set they will be incentivised to set the cap at an arbitrarily high level, which would be counter-productive.

What should be disclosed to clients?

Because we propose that the above budget setting process will remain in place, **onerous reporting processes are not required**. If the new research regime is to be successful, reporting obligations need to be economically viable and not overly burdensome for firms. Disclosures should continue to be simple and articulate key principles as to how a firm uses third-party research to the benefit of clients.

Cost disclosures should be part of the firm's ordinary regime for making fee disclosures, rather than a discrete item. Any audit requirement should be aligned with the firm's broader requirement to produce audited accounts.

Disclosures to clients could potentially include:

- Whether investment managers intend to charge them for research.
- How the firm utilises research and the extent to which this is used to benefit a segment or the entirety of its client base.
- The methodology used to determine the selection of research providers, the assessment of the value of research received, and the reasonableness of research providers' compensation.
- A description of how the firm ensures that research arrangements do not result in best execution concerns and how any perceived conflicts of interest are mitigated.

- A high-level description of the manner in which payments are calculated.
- The most significant research providers utilised (on a firm rather than a client level) and, for equities, a high-level description of the CSA arrangements in place, again available upon client request and on a confidential basis.

Disclosures should *not* include:

- The overall research budget of the firm – this is commercially sensitive information which would optically disadvantage firms that utilise more internal research capabilities.
- The amount paid to each research provider – again, this is commercially sensitive, may result in driving down rates, and may have anti-competitive impacts in terms of benefitting larger asset managers.

Disclosure requirements should not extend to those asset managers who continue to pay for their research via profit and loss (P&L)[4].

Should clients have to consent to bundled payments?

Client consent to bundled payments should not be required (subject to any pre-existing contractual arrangements between parties). Disclosure should be sufficient. Investment managers should disclose to clients how they intend to pay for research, but if consent is required it raises questions as to what happens if a client wishes to opt out – the operational challenges created by a system where some clients pay for research and others do not would be unmanageable for some firms.

Allocation to providers

The IRR proposes that buy-side firms should have a structure for the allocation of payments between the different research providers. As noted above, for equities, CSAs, could form an important part of any payment optionality framework. Among other benefits they allow independent research providers (who, as they do not execute trades, could not otherwise be paid through soft commissions) to form part of the 'research ecosystem', as well as serving to manage conflicts of interest in the trade execution process.

Corporate access

We advocate for corporate access to be included in any bundled regime. Not permitting the same level of optionality as research could result in members being required to run separate payment constructs leading to additional operational complexity. The rules have made it much harder for smaller fund managers, as opposed to larger managers, to get as much corporate access and to inform their full investment process. Creating greater opportunities for members to directly access SMEs/corporates at events is an integral part of the investment decision making process. This is as important as finding structures to improve availability and quality of research – therefore not addressing this consistently may reduce the overall potential benefits of the research bundling optionality.

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[4] Where a buy side firm pays for research sing its own resources (which therefore represents a cost on its own profit and loss account).

In this regard, the UK is also an outlier compared to other jurisdictions; the US approach to corporate access is more flexible and the EU, which has interpreted rules more flexibly, is also reviewing this area. The FCA should revisit this in light of their new secondary competitiveness objective.

Other considerations

- Payment optionality must be practicable. While research payment accounts (RPAs) were intended to provide a more transparent arrangement for paying for research, the operational requirements for RPAs are so challenging and costly that firms were in practice discouraged from using them. The FCA should consider the practicalities of any new requirements to ensure that they do not lead to non-implementation.
- As noted above, future regulatory changes should reflect the uniquely global nature of research. Further changes to the UK's regulatory and legislative environment should where possible align with other jurisdictions. Additional costs borne from a disparate UK regime will further disadvantage the UK market. However, the introduction of payment optionality in the EU should not be a prerequisite for these reforms in the UK; the FCA should implement this reform as soon as practicable', noting that firms will benefit from changes being in place by late 2024, ahead of January 2025 when the next billing cycle starts.
- Research is just one aspect of a much wider discussion on how to incentivise investment into UK companies and enhance UK competitiveness. We ask that the FCA refers to TheCityUK's July 2023 paper 'Recommendations to revitalise UK public equity markets'.
- The FCA should have clear measures in mind for what would be considered a successful outcome for the introduction of additional payment optionality. One possible KPI could be an increase in research coverage. We look forward to seeing how the FCA intends to measure success.

Conclusion

This paper sets out industry wide support for reintroduction of payment optionality for research and calls upon the FCA to implement this change as soon as feasible. Detailed cross-industry consultation on a specific framework will be needed before any changes are implemented. We look forward to continuing to work closely with the industry and the FCA on refining the UK's regulatory regime for research.

Annex: TheCityUK's Capital Markets Group member firms

Addleshaw Goddard LLP
Allen & Overy LLP
Aquis Exchange
Association for Financial Markets in Europe (AFME)
Association of British Insurers (ABI)
Baker McKenzie LLP
Bank of America
Barclays plc
BlackRock
BNP Paribas
British Private Equity and Venture Capital Association (BVCA)
Cboe Europe
Citigroup
City of London Corporation
Deutsche Numis
DLA Piper UK LLP
Euroclear UK & International Limited
Fidelity International
Goldman Sachs
HSBC Holdings
Invesco
Investec Bank
J.P. Morgan
KPMG
Linklaters LLP
London Stock Exchange Group
Mayer Brown International LLP
Morgan Stanley & Co. International plc
Newton Investment Management
Pensions and Lifetime Savings Association (PLSA)
Phoenix Group
PrimaryBid
PwC
Rothschild & Co
Schroders
Simmons & Simmons
Slaughter and May
Société Générale
The Investment Association
UBS
UK Finance
XTX Markets