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Payments for Research: AMF Task Force fires an early shot in the MiFID II Review Process

Francis Land - Director; Brokerage, Research, Sales & Trading

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What Has Happened?

The MiFID II Directive came into application on January 3, 2018. With it came seismic changes to the way that asset management companies monitor, assess, budget and pay for research services in order to comply with the application of the Directive by local regulators.

A task force originally set up in July 2019 by the Autorité des Marchés Financiérs (AMF), the French Financial Services Regulator and reporting in February 2020 has voiced some serious concerns about the impact that the Directive has had on the investment research industry, particularly research production capacity and especially for coverage small and mid-cap companies.

They argue that these reforms were introduced without prior debate, without preliminary impact analysis, and that the problems they identify will not only adversely affect the investment management industry, but also the wider French economy.

What's the significance of this Report?

The AMF Task Force's Report, entitled "Reviving Research in the Wake of MiFID II" represents an important statement of intent on behalf of the French Regulator, one of the more influential European regulators.

Work on the review of MiFID II is already underway. The European Commission issued a consultation on 17 February that include a number of questions on how the quality of and access to research on small and medium sized companies could be improved. The Task Force's Report is a strong indication that the review will lead to meaningful changes to the current Directive.

The AMF argued against regulations in research payments during the development of MiFID II, disagreeing strongly with the UK's FCA. For the AMF's Task Force to voice concerns now on with the impact of the regulations is not a surprise, but the formal and public nature of the AMF's task force is important as we try to anticipate the results of the upcoming review and predict impacts on asset managers, brokers and other research providers.

What problems have the AMF Task Force identified?

The market was already facing challenges.

- The changes to research rules were introduced in difficult macroeconomic climate for active management with declining primary capital markets, thriving passive management and increasingly attractive private equity.
- Year on year fund outflows in French equity funds reached €24 billion in June 2019, causing fee reductions and revenue falls for asset management firms. The fall in revenues impacted on bought services, such as research.
- The long-standing shortage of small and mid-cap stocks has been exacerbated by MiFID II and has potentially wide-ranging consequences for the French economy as a whole
- The French research market is for the most part concentrated on large caps with independent providers representing less than 10% of the players. The analyst population has declined since MiFID I. Coverage of small and mid-caps with their relatively small market caps and free float has continued to decline despite efforts by the marketplace to reverse the trend.
- Here, the AMF Task Force looks beyond the impact on the asset management industry and considers this a much broader problem for "financing the (French) economy". They state there is a close link between quantity of research, the appeal of stocks to investors, and their liquidity. A negative trend in research coverage can create a negative spiral in the visibility and attractiveness of companies to issuers, impacting on their ability to finance and grow themselves.

Market sentiment on the Research Reforms is overwhelmingly negative and prospects for the future are pessimistic.

- The Reform was introduced without political debate or initial impact analysis
- Interviews conducted by the Task Force with Paris market participants "almost universally" quoted negative effects, both quantitative and qualitative, on research especially for small and mid caps.
- Europe is still the only major region to have adopted unbundling (the Task Force contrasts this with the continued use of commissions and soft dollars (known more now as "CSAs/CCAs") as the means to pay for research.
- Positive comments from the market on the new ability to put a price on research, removing the concept of "free" research.
- Effect on corporate coverage (already seen as lower following rules by most players) is actually the last visible effect; research firms will first increase the size of each analyst's portfolio first, (diluting coverage) rather than reducing coverage straight away.
- Reported drops in research provider revenue range from 20-30% on average for 2019, up to 50% in most cases coming after difficult years in 2018. Research firms are additionally vulnerable as other sources of revenue (where relevant) such as execution revenues have also been challenged by small transaction volumes and fierce competition, pushing price down.
- Task Force estimated a drop in the number of analysts of 12% in the eighteen months between end of 2017 and 30 June 2019.

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The market is finding alternatives to traditional research provision.

- There is an increasing use of corporate issuer paid "sponsored" research to offset decline in research. Some research providers, previously opposed to this type of coverage because of independence concerns are now considering including it in their offer, while fund managers are already using it.

Concerns about quality of research

- 44 of sellside analysts consider that research quality has fallen (study by CFA Institute France) especially for SME companies.
- Respondents to Task Force identify that analyses are shorter, less substantial and more neutral; a larger number of stocks is covered by each analyst (AMF analysis shows 11% increase in number of stocks covered by each analyst between December 2017 and June 2019) and average length of analysts' experience has fallen (known as "juniorisation").

Trial periods have had an adverse effect

- Three-month trial periods for new research, designed to offer a compromise in enabling fund managers to try new research before buying while also managing conflicts of interest, clashes with the 6-month research cycle and freezes market share. Respondents questioned the relevance of trial periods to independent research providers, whose visibility is ensured entirely by sending research examples, rather than being provided by other products.
- Since trial periods consider the buyside entity rather than the individual manager or product line, a research provider cannot target any other part of the institution until one year has expired, hampering marketing opportunities.

Firms paying "P and L" have created a new constriction to research consumption – their Finance Department

- By making research payments a cost centre of the firm, the Finance Department has to approve budgets and payments and therefore take a far more prominent role in research selection. Some respondents regretted that fund managers are not now sufficiently represented in broker review meetings.
- By way of example some management firms stated that between 2017 and 2019 they have reduced by two-thirds their number of research providers, leading to a reduction in external research budgets.
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Despite forcing producers and consumers to assign a price for research, pricing is still unclear. Fierce competition has come at the expense of certain firms.

- The Regulation did not define its rules on research pricing, preferring to leave it to market forces and creating a "destabilised" competitive position for European firms. Price negotiation is described now as highly competitive with continual down pressure on price.
- Reforms have undermined the research market, with reduced capacity for research providers and an explicit cost item for consumers. Firms have adapted in a deflationary context with SME coverage especially effected notably due to the disappearance of cross-subsidies.

What are the Task Force's Recommendations?

- Modify rules to introduce a form of "adequation" between the price of research and its cost of production.
- AMF should establish a new independent research economy with a temporary "virtual research marketplace" to increase supply for SME research and support providers with capital.
- Public finance should support research production for innovative companies.
- Encourage new forms of research for example ESG research by acting on certification of analysts.
- Support development of issuer-sponsored research industry by defining good practice and a regulatory framework, regulated by the French Society of Financial Analysts. Discussions should take place at the European level.
- Consider incentives for investment in SMEs by encouraging them to be considered in a manner similar to stocks considered as "Socially Responsible Investment".

What are their Proposed Changes to MiFID II?

- In addition to the "Reasonable Commercial Basis" for market data, extend this to research.
- To create a separation between "concierge services" and "corporate access", consider concierge services as a minor non-monetary benefit.
- Ease trial period restrictions by enabling consumers to use more than one trial period with a certain provider, but on different classes of instrument (equities, bonds etc.). Extend trial periods and reduce gap between trial periods to six months.
- Consider adding "proportionality" to research funding rules, either on small cap stocks (full or partial exemption) or on small research consumers (for example based on AUM or amount of research spending).
- For smaller consumers, administration involved with compliance could be simplified for example in the operation of Research Payment Accounts or removing the need to budget ex ante or the need to get client approval.
- Independent Research Providers (defined as offering no services other than research) should be exempted from MiFID II and covered by other provisions.
- ESMA should conduct a broader qualitative and quantitative review into the concept of whether research should be a part of the inducements system. They suggest only free, or clearly undervalued research should be considered as part of inducements rules.

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Our Conclusions

As remarked in my introduction, this is an important report, albeit from a Task Force rather than the actual Regulator. It is public and forthright in its opinions on the current situation in the research market and the need for real change.

They may have chosen to restrict their recommendations to matters relating to the AMF's jurisdiction, i.e. the French Market place, and they do indeed have suggestions as outlined above. However, they go much further they pre-empt the MiFID II review and suggest some significant changes to the rules that can only be put into effect at the European level. This is very likely to be the French position in any upcoming negotiation.

In the light of this, we can expect significant changes to MiFID II, particularly aimed at boosting coverage of SME companies.

Important to note that they do not propose a significant return to commission "bundling" nor a revocation of P&L payments for research. Asset Management Firms will still need to implement and manage an efficient research evaluation, tracking and payment process however they pay for research and whatever types of research they consume.

We will keep clients informed as we move through the MiFID II consultation process and towards proposals for legislative changes later this year.

Francis Land
Director; Brokerage, Research, Sales & Trading

For more information www.ihsmarkit.com

CUSTOMER CARE AMERICAS
T +1 800 447 2273
+1 303 858 6187 (Outside US/Canada)

CUSTOMER CARE EUROPE, MIDDLE EAST, AFRICA
T +44 1344 328 300

CUSTOMER CARE ASIA PACIFIC
T +604 291 3600

E CustomerCare@ihsmarkit.com

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