EFAMA

European Fund and Asset Management Association

EFAMA POSITION PAPER ON EC CONSULTATION PAPER ON COVID-19'S "CAPITAL MARKETS RECOVERY PACKAGE" – INVESTMENT RESEARCH FOR SME AND FIXED INCOME INSTRUMENTS

11 September 2020

Rue Marie-Thérèse 11 | B-1000 Bruxelles
T +32 2 513 39 69 | info@efama.org | www.efama.org
EU transparency register: 3373670692-24

EFAMA REPLY TO EUROPEAN COMMISSION COVID-19'S "CAPITAL MARKETS RECOVERY PACKAGE" – INVESTMENT RESEARCH FOR SME AND FIXED INCOME INSTRUMENTS

(1) INTRODUCTORY REMARKS

A. Swift, but…

EFAMA[1] appreciates that the European Commission is pursuing an alleviation of certain MiFID II requirements in the interest of promoting a swift recovery from the economic crisis precipitated by the COVID-19 pandemic. Loosening research and execution unbundling requirements when the research relates to small and mid-cap companies is one of several measures envisaged to improve the visibility and financing opportunities of SME companies during the recovery.

We note that, according to ESMA's findings[2], the decline in SME research coverage is a long-standing trend which pre-existed the entry of application of MiFID II research unbundling rules.

Financial market participants and investors have adjusted their practices to the unbundling requirements, and - while the market is still in the 'price discovery' phase - have largely adapted to the new landscape. We, therefore, **welcome** the **optionality of the regime proposed**. Introducing a compulsory set of specific requirements for research relating to SMEs would indeed significantly increase operational complexity for all market participants involved, including asset managers.

We also consider that the proposal to adapt the regime applicable to research on fixed income instruments is a positive step forward. We welcome in particular **the recognition that trading in fixed income instruments is fundamentally different** to equity trading and that obliging investment firms to create an additional artificial payment for fixed income and macro research increased costs, would not bring any benefits for end-investors.

B. … there are more effective ways to foster SMEs' access to markets.

To achieve the European Commission's objective support the EU's economic recoveryto promote the European economy, we would strongly recommend the European Commission to consider the following measures[3]:

- **Sponsored research** can play an important role in facilitating SME's access to market-based financing, provided that it is clarified that it can be regarded as 'minor non-monetary benefit' and that the rules applicable to pre-IPO research are confirmed,
- **Free trial**, i.e. the period during which the issuer can adapt its offering based on investors' feedback, should be extended to six months.

[1] EFAMA, is the voice of the European investment management industry, representing 28 member associations, 59 corporate members and 22 associate members. At end 2018, total net assets of European investment fund reached EUR 15.2 trillion. There assets were managed by almost 62,000 investment funds, of which more than 33,000 were Undertakings for Collective Investments in Transferable Securities (UCITS) funds, with the remaining funds composed of Alternative Investment Funds (AIFs).

[2] See ESMA's assessment contained in their second 2020 report on trends, risks and vulnerabilities in relation to SMEs

[3] See our full views here.

C. Quick Fixes should not alter the need to improve other aspects of MiFID II

We believe that a deeper review of MiFID remains necessary, at least in the following areas:

- **data quality and data costs**. Data costs are surging. We therefore call on the Commission to enforce the creation of a consolidated tape for all financial instruments, starting with post-trade data
- **Liquidity protection**. We need all sources of liquidity to deliver the best results to our clients, including the Systematic Internalisers,
- **Trading burdens**. The Share Trading Obligation (STO) and the Derivatives Trading Obligations (DTO) should be completely removed,
- **Professional investors and eligible counterparties**. These types of investors should either be allowed to opt-out of many cost disclosure or should be out of scope, being allowed to opt-in.
- **Client categories**. The creation of a fourth client category should be avoided and could be achieved by (1) calibrating the types of institutional clients to opt-up under certain conditions and (2) providing a flexible regime for professional investors.

(2) REPLY TO QUESTIONNAIRE

EFAMA **appreciates that the European Commission** is pursuing an **alleviation of certain MiFID II requirements** in the interest of promoting a swift recovery from the economic crisis precipitated by the COVID-19 pandemic.

We see *per* se **merit in the proposed delegated directive, allowing the optional bundled payment of investment research** for small and mid-cap companies.

While we welcome the reforms to enhance the visibility of small and mid-cap issuers, we fear that these changes will not have the expected significant impact on the provision of additional funding to European companies: the decline in research into SMEs had begun well before 2018, and MiFID II's unbundling rules were a contributing, factor, at least in some markets.

In addition, clients are now empowered to see how payment for research contributes to their overall costs and better judge the quality of service they are receiving. The research unbundling rules have also allowed investors to determine whether the obligation to deliver best execution has been delivered on. We consider it unlikely that clients will accept a "re-bundling" of research payments to their commission rates. Indeed, there is a possibility that the bundling of research and execution costs in the case of SME shares, and the resultant lower transparency, may in fact deter investors from investing in SMEs stock.

While there may be scope for regulatory interventions, there should also be an acknowledgement that part of the onus lies with SMEs themselves to demonstrate an appetite for market financing instead of bank financing and to raise their profile with prospective investors.

This is however challenging as financial markets are technical, and it will not be readily apparent how to engage institutional investors.

Therefore, if the European Commission's objective is to improve the visibility of SMEs, we believe that transparency in the market between buy-side and sell-side would be more beneficial in providing a platform to promote better SME research provision.

We also support the disapplication of the unbundling requirement to instruments that trade on a principal basis, where the application of the unbundling rules has mainly led to additional costs.

Reintroducing bundling has multiple challenges:

Although we understand the Commission's reasons for wanting to concentrate the re-bundling opportunity on SME instruments and fixed income instruments, we must point out that this significantly diminishes the incentive for firms to take advantage of the regime, since all but the most specialised of funds would need to run the unbundled large cap regime in tandem with the lighter touch SME one.

The changes as drafted could lead to **several practical and interpretive questions**, so we would propose the following considerations and alternative solutions, which we believe deliver on the Commission's policy objectives while rendering the scheme easier to administer and therefore potentially more attractive to investment firms.

- Threshold calculation

  We would recommend that an annual assessment as to whether an SME qualifies for the lighter regime annually by ESMA. This would deliver stability and clarity since all of Europe would refer to the same list of in-scope SMEs. It is essential that the categorisation of an SME is then stable until the next publication of the list the following year and that all research received during the period of validity of the assessment can benefit from the categorisation.

  In order to facilitate the implementation, we suggest that the European Commission:

- Set the threshold at a minimum of €1bn, but a higher threshold would be highly advisable based on the market structure in several Member States. A higher threshold in countries where SMEs tend to be bigger would make the scheme more attractive.

- ESMA should maintain a list, updated annually, of qualifying SMEs meeting the relevant threshold,

- The threshold should be assessed by 15th November, on the basis of the average market capitalisation over the previous year,

- Insist on the informative nature of the regulatory change, to avoid the administrative burden, the risk of compliance errors and the absence of ineffectiveness of the new regime.

- Balancing measures

The balancing measures in paragraph 11, although well intentioned, are likely to diminish the attractiveness of the sophisticated lighter-touch strategy based algorithms. We would suggest focussing on ex-post transparency to investors, through an annual report on the amount of commission expenditure devoted to the acquisition of research, rather than requiring ex ante amendments to the agreement between investors and managers. The time and cost of renegotiating those agreements would probably make the lighter touch regime uneconomical for the majority of funds, thus defeating the policy objective of making it more economical for funds to acquire research on SMEs.

Although we recognise that this is not a problem that a legislator can or should solve, we believe that standardisation of agreements between the investment firm and the research provider would alleviate the burden on investment firms and would facilitate access to and distribution of research.

- Optionality of the regime and third-country implications.

Because the attractiveness of the lighter touch regime depends on a firm's business model, we entirely support the optionality of the regime. To make sure that such optionality does not adversely affect existing third country arrangements in respect of MiFID firms (e.g. the US SEC no action letters), the vast majority of our members urge the Commission to limit the scope of the optional lighter touch regime to companies with a primary EU listing.

- Fixed income, currencies, commodities and macroeconomic research

It is unclear how the requirement for the application of the derogation (Article 1(11)(a)) could apply to fixed income instruments, as the research costs are not embedded in spread.

We commend the Commission for seeking to recognise in the rules that trading in fixed income instruments is fundamentally different to equity trading and that obliging investment firms in 2018 to create an additional artificial payment for fixed income and macro research increased costs for asset managers not only through the additional fees that were required but also due to the red tape associated with them. As had been widely forecast, bid-offer spreads did not change.

The Commission's approach of focussing the scope of unbundling rules to financial instruments that trade on a commission basis correctly concentrates regulation on the investor protection risks, releasing resources and, increasing the availability of research on fixed income, currencies, commodities and on macroeconomic matters. We urge the Commission to amend recital 28 to make it clear that the exemption from unbundling should focus on the nature of the trading of the investment firms to reflect that transactions in fixed income, currency and commodity instruments do not have a separately identifiable research charge in the spread. As a result, an investment firm that undertakes transactions in FICC instruments on a principal basis should no longer be mandated by regulation to pay an additional fee, as is presently required under Article 13, to obtain research.

Additional channels to improve the visibility of SMEs.

To support the European Commission's efforts to promote the European economy, we urge the European Commission to consider the following investment channels:

- **Sponsored research.**

We consider that sponsored research could improve the EU business to reach investment, provided that minor interpretation issues in connection with pre-IPO research are confirmed.

Rules about issuer-sponsored research are clear and should be maintained, especially as far as the requirement for clear labelling is concerned.

Regarding the interpretative aspects, we believe that issuer-sponsored research, as defined in Article 12 of the Delegated Directive (EU) 2017-593 ensures the accessibility and the transparency on the "sponsored" character of this research to investors and falls within the definition of an acceptable minor non-monetary benefit. We consider that, where issuer-sponsored research meets the conditions of Article 12 of Delegated Directive (EU) 2017/59, it can qualify as an acceptable minor non-monetary benefit. One condition is that the relationship between the third party firm and the issuer is clearly disclosed (cf. art. 36 of Dreg (EU0 2017/565) and that the information is made available at the same time to any investment firm wishing to receive it or to the general public.

In addition, we consider that qualifying issuer-sponsored research as a minor non-monetary benefit, such as defined by Article 12, will support the development of issuer-sponsored research for the SMEs market.

We also consider that the framework arising out of art. 36 of Dreg (EU) 2017/565 (i.e. the existing guidance relating to conflicts of interest management, clarity in communications, and rules relating to marketing communications) is clear and does not need further amendment.

…but rules on pre-IPO research would benefit from further clarity

We believe that the role and structure of pre-IPO (or other transactional) research produced by the research department of an investment firm to educate potential investors in the new issue should also be fostered to increase investments in SMEs.

It should be made clear that pre-IPO research of this type, although not paid for by the issuer, can still be distributed free of charge to potential investors, as an acceptable minor non-monetary benefit, if it meets the conditions of Article 12 of Delegated Directive (EU) 2017/593. This is currently the position (thanks to NCA guidance) in some, but not all, EU markets.

We believe the rationale for this assessment is strong – where research is produced in advance of an IPO (or other capital markets transaction), it is produced in order that a potential investor base can better understand the investment proposition, and is made available to numerous potential investors.

- **Extension of free trials.**

Free trial, i.e. the period during which the issuer can adapt its offering based on investors' feedback, should be extended to six months. We do not believe that three months is enough to develop a clear view on the value of a specific research provider. Amending rules on free trial periods of research would be more relevant because under current rules we are subject to twelve months freezing period between two trial periods.

We suggest:

- reducing this freezing period to six months with the aim of facilitating competition between providers,
- extending the trial period from three to six months, or
- putting a cap on the number of free trials without any time limit.