Euro IRP
The European Association of Independent Research Providers

Formal response from The European Association of Independent Research Providers (Euro IRP) to The European Securities and Markets Authority (ESMA) MiFID II/MiFIR Consultation Paper

Members should be aware that ESMA will publish all responses received to the consultation paper by the end of the consultation period.

The following response to Question 79 *(Do you agree with the proposed exhaustive list of minor non-monetary benefits that are acceptable? Should any other benefits be included on the list? If so, please explain)* of the consultation paper will be submitted via online submission to reach EMSA by 1 August 2014.

European Association of Independent Research Providers (Euro IRP) - overview

Euro IRP is a European trade association representing the interests of independent research providers for institutional fund managers.

By "independent" we mean that we operate business models that provide research without potential conflicts of interest. Members are required to attest that:

- *Member is not in the business of providing investment banking services or management consulting services to publicly-traded companies.*
- *Member is not affiliated with, or a subsidiary of, any entity that provides investment banking services or management consulting services to publicly- traded companies.*
- *Member's primary revenue source is not from companies who have commissioned research about themselves.*
- *Member is in good standing with all relevant regulatory authorities.*

Summary of **Euro IRP** view

While applauding an attempt to improve the efficiency of the research market across Europe, we believe that the currently-proposed ESMA technical advice is a dangerous compromise. It doesn't go far enough to ensure a truly competitive, level playing field, while potentially (depending upon interpretation) it goes too far in possibly generating dangerous, unanticipated consequences.

There are also confusions in the text that will allow a great deal of leeway for Investment Banks and Brokerages and/or local regulators to interpret the rules in a variety of different ways. Some of this confusion relates to apparent inconsistencies between the analysis and the draft text.

However, just as importantly, the objectives of this section seem to be undecided: is it addressing potential issues in the provision of services by IFAs to the individual/retail market OR the very different issues embedded in the market for the provision of valuably-resourced research to the institutional portfolio manager? **The two markets are very different and require different solutions.**

Three key considerations:

1. As un-conflicted research providers we are very concerned that some of the interpretations ESMA has made in relation to the Level 1 MiFID legislation could have severe unanticipated and, we believe, unintended consequences for the Institutional portfolio management sector of the market, which we primarily service. We therefore DO NOT AGREE with the proposed exhaustive list of minor non-monetary benefits.
2. The ESMA draft technical advice reflects the fact that "*MiFID I contains requirements for third party payments in the context of Article 26(b) of the MiFID Implementing Directive, regulating inducements.*" So the advice interprets the inducements to include investment research as an inducement that needs to be controlled. However, it is not clear to us that this was the underlying intention (that impacts Institutional Portfolio Managers) of the legislators at Level 1 as the original clauses appear to be primarily aimed at preventing retail financial advisers from receiving inappropriate rewards which could cause conflicts of interest.
3. To be clear, we share the aspirations of regulators around Europe to see a significant reform of the institutional investment research marketplace. We agree that there is a widespread lack of transparency in pricing, an over-supply of low quality research, a lack of appropriate research service valuation methodologies (which disadvantages independents at the expense of cross-subsidised investment banks), payments for investment banking services masquerading as research payments and a lack of budget control over research payments to the detriment of end-clients. However, we feel that the draft technical guidance includes compromises that could worsen an already-difficult situation. It appears to go either not far enough or too far.

First: our proposition that the draft guidance doesn't go far enough.
If this interpretation holds following consultation, then we would argue that it should apply to **ALL** investment research***, i.e. no research should be considered a minor non-monetary benefit***. The exemption granted to widely-disseminated, generic research seems to be targeted at "Independent investment advisers and portfolio managers" but would appear to allow the interpretation that the full service investment banks may receive payment via client commissions for low-value research while preventing independents or others from receiving CSA payments for high-value research. This appears perverse. If the provision of investment research is to be considered an inducement, then all research should be covered by the rules by modifying *"3. Investment firms providing the service of independent (and non-independent) investment advice and portfolio management are not allowed to receive non-monetary benefits [DELETE that do not qualify as minor.]"*

There is also a serious issue in that the draft technical advice appears to contradict the analysis earlier in section 14. This analysis states that:

"any research that is tailored or bespoke in its content or rationed in how it is distributed or accessed would be of a scale and nature such that its provision is likely to influence the recipient's behaviour and cannot be a minor non-monetary benefit".

However the draft technical advice states that the exhaustive list of minor non-monetary benefits should include:

"i. information or documentation relating to a financial instrument (including financial research) or an investment service. This information could be generic in nature or personalised to reflect the

circumstances of an individual client;" This may be intended for the level of an individual rather than an institutional portfolio manager, but the distinction needs to be sharp to prevent abuse.

Not only does there appear to be a contradiction relating to personalisation/tailoring, but the definition of minor non-monetary benefits in the technical advice could be interpreted as saying that all investment research is considered a minor non-monetary benefit. There is a great deal of scope for confusion here, with different institutional portfolio management firms (the `buy side') deciding on very different approaches to the payment mechanism for research.

Finally on this point, by specifying narrowly that "minor non-monetary benefits" relate to information or documentation relating to a financial instrument, it implies that macro-economic or investment strategy advice is not covered by the minor non-monetary exemption. This would severely damage the ability of independents and others providing asset allocation advice to compete effectively for payments with firms providing "maintenance" research on individual stocks and credits. Moreover, MiFID I Art 24 defines "research" much more broadly in the way that it would be used in wholesale markets.

We do not agree with the concept of an exhaustive list of minor non-monetary benefits that includes research.

IF RESEARCH IS AN INDUCEMENT, THEN ALL RESEARCH MUST BE EXCLUDED FROM PAYMENT BY COMMISSSION

Second: our proposition of the possibility that the interpretation goes too far.
By explicitly stating (in the analysis if not in the draft advice) that investment research is considered an inducement, ESMA's advice may be understood by the market to mean that the practice of using client commissions to pay for research (either directly or via CSAs) will be forbidden. Many market participants view this as a disproportionate response to the problems that need solving. It has the potential to generate many unanticipated and unwelcome consequences and could potentially produce a less competitive and efficient research market than currently exists.

The potential unanticipated consequences include:

1. An immediate and significant reduction in total research spend – potentially to levels that damage the asset managers' ability to maintain or grow investment returns.
2. The danger that focussed research providers – including the independents – could see a disproportionate cut in research payments as institutional portfolio management firms (the buy-side) attempt to protect their broader (non-research) relationships with the investment banks. This would reduce actual and potential competition in the market.
3. Regardless of (2), the investment banks have a stronger ability to survive a scarcity of research payments due to their ability to cross subsidise their research operations. Again, this would reduce competition.
4. A potential squeeze on the profit margins of asset managers, resulting in further consolidation of managers, greater concentration of risk, a reduction in competition and increased barriers of entry for new innovative mangers.

It is likely that the damaging impacts of these unanticipated consequences would outweigh positive results from outlawing the use of commissions to pay for research unless significant regulatory focus

was placed on the transition to the new environment, particularly in regard to implementation of much more stringent best-execution rules. This would require additional regulation to control the activities of both the investment banks (sell-side) and institutional portfolio management firms (buy-side) during the transition to ensure competition was not adversely affected.

If the regulatory discussions determine that commission payments for valuably-resourced research are not seen as inducements - and therefore not banned - we would argue that conflicts of interest can be mitigated by explicitly allowing CSAs across the EU.

If the problem is that provision of research is seen as an inducement to trade with a particular broker, then an explicit endorsement of CSAs would help break this link and so assist in moving towards an "unbundled" world.

Progress from FCA actions in the UK
Within the UK, the FCA has already set in train (via DP14/03) steps toward making all research appropriately and fairly valued across all providers, with appropriate research budgets set and managed. The FCA commented that *"UK investment managers pay an estimated £3bn of dealing commissions per year to brokers, with around £1.5bn of this spent on research. These transaction costs are borne directly by investment managers' customers. We have had ongoing concerns about investment managers' controls over the use of dealing commissions and the conflicts of interest it creates for them as agents to their customers, given the lack of transparency of these costs. This is exacerbated by the largely unpriced and opaque market for research."*

So price transparency across all sectors of the research market is the initial goal but the FCA sent the key message that "*Overall, we conclude that unbundling research from dealing commissions would be the most effective option to address the continued impact of the conflicts of interest created for investment managers by the use of a transaction cost to fund external research."* The risk is that with the loss of commissions being permitted to pay for research, whatever pricing structure emerges in the near future for research paid via dealing commissions, this structure may prove invalid post-2016 if fund managers then have to pay for research as a direct business expense. That development may prove particularly difficult for the independent research sector. Specific actions to prevent buy-side and sell-side firms colluding in the use of commissions to pay for services that are neither research nor execution would be extremely helpful.