Euro IRP
The European Association of Independent Research Providers

Wholesale Conduct Policy Team
Markets Division
Financial Conduct Authority
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Canary Wharf
London
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6th October 2014

Dear Sirs,

Discussion Paper DP14/3
Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research July 2014
Comments – The European Association of Independent Research Providers (Euro IRP)

Euro IRP (The European Association of Independent Research Providers) represents the interests of the European independent investment research industry. It was set up in 2005 with the following four goals:

- To enhance the awareness and reputation of independent research
- To change the perception that research is free
- To work with regulators and investors to promote the awareness and acceptance of payment structures
- To improve the regulatory and fiscal environment in which independent research firms operate

We currently represent 56 member firms as well as having close links with Investorside and Asia IRP, the US and Asian associations for Independent Research Providers (IRPs).

A small minority of our members offer a combination of execution and research services, while the majority are solely in the business of offering research services alone. All members attest to the following statements of independence:

1. The member is not in the business of providing investment banking services or management consulting services to publicly-traded companies
2. The member is not affiliated with, or a subsidiary of, any entity that provides investment banking services or management consulting services to publicly-traded companies
3. The member's primary revenue source is not from companies who have commissioned research about themselves
4. The member is in good standing with all relevant regulatory authorities
5. The member is not operating an Expert Network Business

The FCA has requested answers to two questions following the publication of DP14/3. These are:

Q1: Do you have any comments on our analysis on the potential impact of unbundling payments for research from execution arrangements, based on MiFID II proposals?'

Q2: Do you have any analysis that would help inform our view of possible benefits or costs of extending requirements in MiFID II to cover all research goods and services?

We offer our answers to both questions below. In order to be as clear as possible we have referenced what we believe are key sections in the FCA's Discussion Paper (in italics) and provided comments to each of these. We also note that there is still considerable uncertainty and industry comment around the drafting in ESMA's documentation and its intentions with respect to the inclusion of research as an inducement under MiFID II.

Q1: Do you have any comments on our analysis on the potential impact of unbundling payments for research from execution arrangements, based on MiFID II proposals?'

Euro IRP agrees that the existing research market is both inefficient, generating wasted output and higher costs for the end client, and is tilted strongly in favour of the investment banks, which can cross-subsidise their research offerings at the expense of the IRPs. However, we are very concerned that, in the absence of a clear transition process, and focus on the clear separation of each service provided to investment managers by investment banks, the transition from the current environment to a new research market could be extremely perilous for IRPs. As a result, and as we will explain below, it is on this basis that we would prefer an evolutionary rather than revolutionary transformation of the market.

POINT SPECIFIC COMMENTS ON FCA ANALYSIS

Section 1.11
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. We believe it would drive more efficient price formation and competition in the supply of research, removing the current opacity in the market. It would be particularly effective if this reform can be achieved on an EU-wide basis.

While we can appreciate the logic underpinning this point, we are only beginning to see attempts to build a new valuation and pricing structure for the payment of research that may yet achieve these aims. The risk is that with the loss of commissions being permitted to pay for research in just over two years, the new structures 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 unless specific action is taken to prevent the use of commissions to pay for services that are neither research nor execution.

Section 1.29

- *Despite some of the arguments for retaining the ability to acquire research using dealing commissions, we view brokers' unpriced bundling of research and execution services as preventing transparent price formation and competition based on the quality of discrete research services. This makes it difficult for independent research providers to compete. It also adds to the challenge faced by investment managers when trying to assess the value for money of research.*
- *Investment banks prefer to bundle research services due to the complexity of their business models. A transparent, priced market for research appears highly unlikely to emerge organically without structural change.*

While some investment banks have begun to consider and plan for a more transparent pricing model, we would agree that progress has been exceedingly slow. The progress that has been made has been largely caused by fund management firms demanding more transparent pricing in anticipation of significant regulatory change. We strongly support the need to keep the pressure on investment managers so that this change becomes embedded across the industry. However, it is also very important that the independent research providers are able to compete on a level playing field, and that the process to get there does not in the near term tilt further in favour of investment banks.

Section 3.28

We found that research is both an internal resource for the investment bank, as well as a 'product' provided directly to their clients. The brokers varied as to whether they allocated research costs internally; when this did occur internal apportionment differed between firms. There was only one broker that treated their research as a completely standalone product, including from execution services, and so only received research dealing commission payments for that discrete service.

Euro IRP believes that this has been and remains an issue in the market. We have anecdotal evidence that some multi/service banks and brokers will use their total costs of research when presenting profitability analysis to the buy-side – hence attempting to cover the full cost of research through buy-side commissions while benefitting significantly from internal usage. In a truly price competitive market this would soon be corrected as the buy-side would seek a better price/quality combination of services. In the current opaque market this competitive correction does not work reliably.

Section 4.6

Bundling also maintains perceptions among investment managers that "it creates the potential for full-service suppliers [investment banks] to discriminate against investment managers in areas unrelated to the provision of research, based on the level of commission spend." This may further distort investment managers' decisions over commission payments and disadvantage independent research providers.

Section 4.31

This has led to some investment managers stating they feel unable to reduce commission payments to investment banks below a certain threshold, to ensure they are still considered for wider ancillary services. This can include corporate access or, as the IMA noted, being *"favoured or prejudiced in the allocations of IPOs, according to their payments of dealing commission".*

Euro IRP certainly agrees that the research market place is tilted in favour of the investment banks, in part, due to their ability to cross-subsidise their research across a range of different businesses, and in part, as a result of this and their other activities, they have been able to collect commission payments, ostensibly made in return for research, but in fact used to reward other, potentially prohibited, services.

The members of Euro IRP, however, have demonstrated that a group of firms with a range of business models are able to compete with the major banks and to produce research profitably. This contrasts with the regular lament from the investment banks that "cash equities is not a profitable business".

That said, we are fully aware that the buy-side places significant value on their "relationships" with investment banks, and if we want to remove this bias from the research pricing process, this needs to be clearly and separately rewarded outside of the payment process for research.

Section 1.34
Independent research providers would be able to compete much more effectively against brokers in a priced, unbundled market for research, and product and service offerings would become more diverse. Brokers would have to demonstrate the value added of their own research offering versus more specialist research providers, and would no longer receive research commissions simply due to trading activity.

While IRPs are able to compete on quality of research and on quality of service, the IRP sector remains relatively small in the UK and Europe, and most firms are not able to grow revenues to a size commensurate with their quality and service levels. We have raised the bar for the industry by offering transparent pricing, by being willing to agree a wide range of different payment models (hard cash, research voting, subscriptions etc.) and by ensuring that the services offered are appropriate to the needs of individual users and/or to departments/organisations as a whole. We believe that the tilted research market has led to the IRP sector as a whole being under-rewarded for the quality and level of service provided and that this in turn has held back the development of the sector.

Section 4.52
Competition distortions are further exacerbated by the tax treatment of research. Based on HMRC's guidance on value-added tax (VAT), market participants generally appear to view bundled broker research as VAT-exempt. By contrast, goods and services from independent research providers paid for through CSAs or directly from an investment manager's own funds are more likely to be viewed as VAT liable.

The VAT issue has provided a 20% price subsidy to the bundled providers of research in the UK for many years. Many buy side firms remain blind to the fact that IRPs are required to pay VAT whereas bundled providers, such as the IBs, are treated as being VAT exempt. This certainly builds yet another competitive barrier and needs to be corrected.

Section 4.66
For a broker, providing a priced research service to investment managers with the optionality to pick and choose to pay only for certain services – for example, access to a single sector of research coverage – simply means the broker may receive less revenue to cover the costs of the broad coverage that they want to provide in any case. The investment banks would also face more direct competition from independent research providers, with more pressure to demonstrate the added value of their research proposition to investment manager. This is likely to mean "high quality, content led research will become a differentiator."

Euro IRP believes that there is a great opportunity for the research sector to expand both in terms of revenues, but also in terms of reach if the marketplace became more transparent and if conflicts of interest were more tightly controlled. Such an expansion would be based on high quality research and service, a much more transparent pricing policy and the ability of smaller nimbler firms to react more rapidly to the changing needs of the various segments of the market.

Q2: Do you have any analysis that would help inform our view of possible benefits or costs of extending requirements in MiFID II to cover all research goods and services?

Section 1.35
We conclude, based on our high-level cost benefit analysis, that we expect significant benefits from unbundling research from dealing commissions, which would outweigh costs to industry or potential negative effects on the market.

While we agree with the broad aim of moving to a more transparent, conflict free research market, we believe the FCA's conclusion that benefits will outweigh the costs, depends entirely upon the transition process and other actions that need to be taken to address the payment for "relationships" in the investment banking sector. The FCA has identified in its analysis a number of ways in which the investment banks benefit from the current regulatory regime. While the fund management industry prides itself on trying to adhere to the spirit of all regulation, the IBs have a reputation of attempting to find loopholes through the regulation and to focus on the "letter of the law" rather than the spirit.

Our concern is therefore that during a transition to a new market structure, which the MIFID II timeline would require, there will be scope for the investment banks to re-model their businesses in order to maintain a tilted playing field. Their ability to cross-subsidise their research means they have an inherent advantage in surviving a period of "research payment drought" from the buy-side. If the buy-side believes that we are moving to a totally unbundled world, they will begin by cutting their research spend considerably. Our anecdotal understanding is that they would, at least initially, be unable or unwilling to raise management fees to cover the full loss of research commissions. Hence, we anticipate a severe squeeze in the revenues of IRPs, which they would not be able to cover in the short to medium term, potentially putting businesses at risk.

Section 5.4
We believe it is unlikely that most investment managers would choose to pay for research based on the 'broker vote' if they were using their own funds. Instead, they would require research providers to set an upfront price for an agreed level and quality of goods and services supplied, which they would review on an ongoing basis. We expect that unbundling research from commissions would create sufficient behavioural change that suppliers, including brokers, would have to price all research in the market.

A reduction in overall commission spend is, we believe, one of the aims of the FCA's proposals. As an association we agree that a market in which less in aggregate is spent on research but in which quality research is more highly valued and better rewarded, would be of benefit to end investors (who would pay a reduced overall fee) and to fund managers (who would spend less time protecting themselves from waves of unwanted research and sales calls). It would also be of benefit to efficient producers of high quality research, amongst whom we would count the members of Euro IRP who have demonstrated during very difficult market times that they can build a profitable "research only" service based on identifying and meeting client needs.

That said, the "research-vote" process has many advantages for investment managers, in particular, the retrospective assessment and payment process. We think this is likely to remain of value in a more unbundled world. We also believe, as set out in our response to ESMA, that conflicts of interest can be mitigated by promoting CSAs across Europe.

Section 5.5
More rigorous governance by the investment manager will also reduce the influence of the wider relationships between fund managers and brokers, and the inference that corporate access or access to IPOs are informally rewarded in commission payments The investment manager will focus on the substance of research goods and services provided.

We agree. However, the danger is that during the initial period of reductions in research spend, the initial instinct of many individual fund managers will be to protect their "relationships" within the major investment banks. If we do appear to be moving to a totally unbundled world all regulators, especially the FCA, will need to stress to the senior management of the buy-side that they expect a re-doubled effort to ensure fair valuation of research (and only of research).

We are concerned that the bulge bracket investment banks may decide that corporate access and other non-research services are "free". This could allow the IBs to continue to cross subsidise their research offerings to the detriment of a competitive, open research market.

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If the ESMA consultation does conclude that investment research is an inducement then all European regulators will need to manage the transition to a "hard dollar" research world extremely carefully in order to avoid unanticipated and unwelcome consequences for the competitive environment.

If regulators across Europe, as part of the MIFID II consultations, decide that we should not move to a "hard dollar" world, Euro IRP would continue to support and press for major changes to the research marketplace. The key changes are, we believe, increased regulatory scrutiny of what is paid for using commissions, appropriate valuation of research from all providers, greater transparency of pricing by research providers and a high level commercial focus at buy side firms on research budget setting. It would also be extremely helpful to an open and competitive market if the level 2 text could include an **explicit** recognition that Commission Sharing Agreements (CSAs) are permitted, and encouraged, under MiFID.

In conclusion, Euro IRP believes strongly that all providers of high quality research can flourish where there is a level play field, and we support the development of greater transparency across the industry and an evolutionary transformation of the market. We are, however, concerned that changes to payment mechanisms alone will not change behaviours without a clear transition process that establishes and then promotes the level playing field, and develops a broader framework for the separate and transparent pricing of the whole "relationship" between the buy and sell-side.

That said, the "research-vote" process has many advantages for investment managers, in particular, the retrospective assessment and payment process, and we think this is likely to remain of value in a more unbundled world.

In addition, and in the absence of a well-managed transition to an unbundled model, we believe it is critically important that those mechanisms in place today, in particular, CSAs, are afforded greater protection and development across Europe. We believe stronger CSA guidelines and Europe-wide promotion could meet many of the conflicts of interest objectives sought by the FCA.

We will of course be available for any questions arising.

Yours sincerely,

Peter Allen, Chairman
The European Association of Independent Research Providers Limited