4th June 2024

**Mr. Nikhil Rathi, CEO, and**
**The Wholesale Markets Sector Team**
Financial Conduct Authority
12 Endeavour Square, London
E20 1JN

**Submitted by e-mail to:** cp24-7@fca.org.uk

Dear Mr. Rathi and the Wholesale Markets Sector Team,

**CFA UK letter in response to the FCA's consultation CP24/7 on "Payment Optionality for Investment Research", April 2024**

The CFA Society of the UK (CFA UK) welcomes the opportunity to respond to the FCA's investment research consultation.

We support measures that may help to grow the investment research sector in the UK, given that many of our members are involved with research on the buy or sell side. We also question the possible efficacy of the proposed new option in achieving a stronger market for investment research.

Our responses to your questions are attached, and key points summarised below.

**Additional context to our response**

Since the initial 2014 consultations on "unbundling", the CFA Institute and CFA UK have stressed that investment research is a key component of a robust free market, and policy makers should consider a framework that supports a fair market for research, with less asymmetric access by any set of players.

Unbundling was supported by us as a measure that mitigated conflicts, noting at the time that transparency and disclosure were also effective alternatives.

While our analysis does not indicate that MiFID was a key reason for declining research coverage, it is also fair to say that MiFID and unbundling failed to propel the development of independent research, and we still face a situation where small companies lack proper coverage, with consequential impacts on IPO's and listings.

Please refer to the Annexure to our responses at the end of this letter for a summary of the insights gathered in this context.

**Key points made in our response**

We understand why the FCA has proposed the third bundled option, given the competitive imperative, and on that basis are supportive. It is also possible that smaller asset managers may access research more easily via this option.

However, given the context in the previous section, we don’t believe that this single measure will have a material impact on achieving the broader sector objectives, and we suggest that the regulatory framework should look beyond this.

We have accordingly made some key comments in our response:

- **Independent research providers (IRPs) and smaller players competitive standing:**
    - The bundled option may potentially exacerbate the competitive disadvantage of IRPs, and a further review of policy measures to support these players is suggested
- **Research on smaller companies:**
    - The third option will not necessarily encourage research on smaller companies and SMEs, which is an issue that separately merits policy makers attention
- **Proposed Guardrails v. conflicts of interest, value for money, and complexity**
    - We have suggested enhancements to the guardrails to preserve the aims of conflicts management, the objectivity of Value for Money assessments, and reducing complexity / “red tape” for smaller players
- **UK’s position in the investment research market**
    - Deregulation is not a panacea for reviving the UK as an investment destination and we are not convinced of the likely impact of the new measure.  We suggest a broader consideration of the factors holding back the UK research sector.

We would be happy to meet and discuss our feedback, if helpful to the FCA.

Yours sincerely,

*Amit Bisaria*

Will Goodhart
Chief Executive
CFA Society of the UK

Amit Bisaria, CFA
Professionalism and Ethics Adviser
CFA Society of the UK

*With thanks for contributions from: Olivier Fines CFA, Chris Bamberry CFA, Suzanne Hsu CFA and the oversight of CFA UK’s Ethics & Professionalism Steering Committee.*

## APPENDIX 1: ABOUT CFA UK AND THE CFA INSTITUTE

**CFA UK** serves nearly 12,000 members of the UK investment profession. Many of our members analyse securities, manage investment portfolios, advise on investments, or are in roles responsible for investment operations or oversight.

Our role is to help investment professionals build and maintain their skills and competencies so that they are technically and ethically competent to meet their obligations to clients. We advocate for high standards of ethical and professional behaviour and our work with regulators, policymakers and standard setters is focused on skills, knowledge and behaviour.

We are not a lobby group or a trade body. We are an independent, professional association whose mission is to 'educate, connect and inspire the investment community to build a sustainable future.'

Founded in 1955, CFA UK is one of the largest member societies of CFA Institute. Most of our members have earned the Chartered Financial Analyst® (CFA®) designation. All our members are required to attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

For more information, visit www.cfauk.org or follow us on Twitter @cfauk and on LinkedIn.com/company/cfa-uk/

**CFA Institute** is the global association for investment professionals that sets the standard for professional excellence and credentials. The institute is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Its aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.

It awards the Chartered Financial Analyst® (CFA) and Certificate in Investment Performance Measurement® (CIPM) designations worldwide, publishes research, conducts professional development programs, and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.

CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.

For more information, visit www.cfainstitute.org.

## RESPONSES TO QUESTIONS

**Q1. Do you agree with our proposal to create additional payment optionality for investment research?**

We understand that the new optionality is motivated by not disadvantaging the UK's access to global research, and on that basis are supportive of it. Also, the "guardrails" preserve some of the original objectives of unbundling such as lack of transparency and budget discipline.

During a recent webinar on this topic with some CFA UK members, a snap poll of attendees (including members involved on the buy-side, sell-side and in other roles, with buy-side being the largest number), indicated the following. _Note this was a very small sample and is only considered accordingly._

- Supportive of the bundled option : 44%
- Not supportive : 4%
- Undecided : 52%

However, we also have some concerns, and suggest consideration of these ahead of finalizing the proposed rules:

- **Independent research providers (IRPs) and smaller players competitive standing:**
    - The bundled option may exacerbate the competitive disadvantage of IRPs, as it further supports large integrated players. We note the pre- MiFID tendency of some players to leverage research for marketing and client trading solicitation, and the risk that this could re-emerge to an extent despite the new guardrails.
- **Research on smaller companies:**
    - While the third option may potentially revive overall budget allocations, the dominance of trading volumes in large companies will not encourage research on smaller companies and SMEs.
- **Proposed Guardrails v. conflicts of interest, value for money, and complexity**
    - Please see our response to Q5. below
- **UK's position in the investment research market**
    - Please see our response to Q11. below

**Q2. Would you be likely to take advantage of the proposed new payment option?**

From the perspective of CFA UK, this is not applicable to us as we are neither a seller nor buyer of investment research.

During our recent webinar, a snap poll of member attendees indicated the below preferences. _Note this was a very small sample and is only considered accordingly._

- Likely to access the bundled option : 41%
- Likely to have client pay : 30%
- Likely to pay themselves : 30%

**Q3. Do you have any views on key indicators that could act as success measures for the outcomes we are looking to achieve?**

Our suggestion is to keep this simple, as an attempt to meet targets such as a % change in buyside budgets or % change in the number of research providers, are likely to fail given the several factors at play. Instead, we suggest review-based assessments of the impact of the new measure, such as:

- **A sectoral review of take up of the 3rd option,** which if done by a material % (say 10 or 20%) of buy side players (assuming offered by a majority of sell side players) would validate the introduction of the option
- **VfM reports sampling**, to assess what % of reports (v. a TBD target) concluded that investment research was delivering client value for money.

**Q4. Is the proposed new payment option and associated guardrails likely to be more efficient and adaptable than existing options for small fast-growing or new entrant firms, or for existing users of RPA's?**

On the face of it, the third option should be easier to adopt, as it is an option and not compulsory, or deadline driven.

However, it probably (unavoidably) risks reintroducing complexity into the sector. While the guardrails mirror the Kent review and are well intentioned, smaller players may perceive some as cumbersome and potentially hinder adoption. We accordingly suggest that the guardrails are moderated for smaller firms, or more time allowed for compliance.

You may also consider some simplifications per se:

- Merge the guardrail on budgeting (4.41) and allocation of payments (4.39) into a single budgeting cum allocation guardrail.
- Replace the value assessment (4.43) with the broader VfM expectations under the Consumer Duty. Assessing overall VfM of the product inclusive of all costs is important, compared to a separate and new VfM exercise only for research.

**Q5. Do the guardrails we are proposing around firms' use of the proposed payment option secure an appropriate degree of protection for consumers?**

Overall, the guardrails look reasonable, also given the presence of Best Execution rules, Consumer Duty obligations, Costs and Charges disclosure etc. in the regulatory framework.

However, we have a few concerns and suggestions:

- **Conflicts of Interest:** The primary aim of unbundling, i.e. avoidance of conflicts of interest, should not be diluted under the new regime. A core principle is to ensure that trading fees generated by a client are used only to benefit that client. While guardrail 4.38 will help, we also suggest:
  - Disclosure and delineation of the cost of trading v. the cost of research is explicitly included in 4.44 disclosure
  - Explicitly including the clarification under 4.45 (i.e. methodology is subject to compliance with Best Execution rules) in the written rule for guardrail 4.38

- A thematic review by the FCA of conflicts management and competitive practices on the sell side, including examples of good and bad practice (an example of the latter being below cost pricing and mainly leveraging research to gain trading business).

➢ **Value for Money:** The VfM requirement on research 4.43 is subject to the risk of subjective and potentially vague and meaningless assessment. This could therefore be replaced by:
- A requirement to disclose investment research cost as a % of AuM
- Confirming the expectation that research is included in overall VfM assessment under the Consumer Duty; ultimately the test of quality, quantity and availability of research is in the impact on investment performance and client access v total client cost.
- VfM must also include the cost of internally produced research, which should also be included under the budgeting and allocation guardrails 4.39 and 4.41.

➢ **Support for IRPs:** The guardrail 4.39 on structure for the allocation of payments feels incomplete without ex post disclosure. Under disclosure guardrail 4.44, we suggest adding a requirement to disclose "category wise" % allocation between IRPs, smaller providers (threshold TBD by FCA) and others (i.e. larger players) regardless of means of payment.

**Q6. Is the proposed new payment option and associated guardrails likely to facilitate operational efficiencies via increased alignment with the requirements of other jurisdictions when purchasing research from overseas providers?**

Yes, regarding alignment with the EU (given their proposed changes). But the associated guardrails may still be relatively onerous for buyers of U.S. generated research compared to U.S. based buy side players.

**Q7. Do you agree with the findings set out in the analysis section of this consultation paper?**

No additional comment; we note that the analysis seems to conclude no direct evidencable impact of MiFID on the trend in research coverage.

**Q8. Are there any features of the proposed payment option and associated guardrails that would positively or negatively impact its take-up by firms?**

Please refer to our response to Q's 1) and 4) above.

We also suggest clarity is provided on VAT treatment. Pre- MiFID bundled payments were exempt from VAT, and the presumption would be that the exemption continues. If not, this could cause further potential complexities, which smaller asset managers can do without.

**Q9. Do you agree with the proposed addition of short-term trading commentary and advice linked to trade execution to the list of acceptable minor non-monetary benefits in COBS 2.3A.19R(5)?**

Yes

**Q10. Do you agree with the deletion of the option for bundled payments to purchase research on companies with a market capitalization below £200 million from the list of acceptable minor non- monetary benefits in COBS 2.3A.19R(5)?**

Agree. We expect that deletion of the option for bundled payments on research for sub-£200m companies in practice will have little impact as it was not utilized by asset managers due to the costs and complexity in differentiating between market caps for payment mechanisms.

**Q11. Are there any further comments you wish us to consider while finalizing these proposals?**

We are doubtful of the direct impact of this measure in achieving a revival of the UK market for investment research. As your analysis also indicates, there are several factors, some of which pre-date the MiFID change, that have contributed to a decline in the production and consumption of investment research in the UK.

The structure of the investment sector has been changing for many years and factors such as the growth in passive investing, focus on dominant sectors such as technology, greater use of quant investment strategies, and the growth of private investments (which rely largely on bespoke or focused research) have had a major impact.

We suggest that further thought is given to initiatives that may have a more direct positive impact, particularly to encourage new entrants, smaller players and IRP's, rather than only focus on de-regulation.

In this context we would emphasize the role of skills and knowledge building in the research sector. The traditional role and value added of investment research has been changing over time, as are the skills and ongoing learning required to operate in the sector. A broader approach will need to consider:

- Positioning UK as a global research center, rather than only a UK companies focus
- Ongoing development of leading skills and knowledge within the sector, including the application of technology
- Quality and availability of research to a wider audience, including retail
- Reducing sectoral limitations of UK research, by applying a global perspective
- Private capital needs are also considered and leveraged to support a revival

**Q12. Do you have any comments on our cost-benefit analysis?**

No

**Q13. Do you hold any information or data that would allow assessing the costs and benefits considered (or not considered) here?**

No

## ANNEXURE TO RESPONSE

CFA Institute has long investigated the dynamics at play in the market for research, in various parts of the world. Several pieces over the last years have analysed this market and the possible impact of regulatory developments. We present a brief overview of this history and main conclusions below.

**In June 2021, the Financial Analysts Journal released a research article which investigated the merits of soft commissions through time as well as the regulatory impact, with a literature review and analysis of existing research on the subject[1].** The authors' approach has been to review 59 relevant publications since the 1975 Safe Harbor Rule and including the reviews published since the enforcement of MiFID II in the EU.

Some of the key conclusions were:

- A majority of publications argued against the use of soft commissions because of the resulting agency conflicts and the additional costs generated by the practice. They would however advocate in favour of a mixed system of bundling and unbundling of commissions to cater to clients' various preferences.

- Most academic literature reviewed found that the conflicts created by the use of soft commissions lead to a decrease in research coverage (quantity and availability) and investment managers' quality of services to clients. Transparency and disclosure were the solution they proposed to mitigate this risk, largely in line with the principles of the CFA Institute Standard.

- Most publications found that the practice of soft commissions lead to higher trading costs and commissions.

- Most publications based on empirical studies found that soft commissions affect fund performance negatively on a net basis. In other words, the benefit from the research obtained through soft commissions is less than the costs generated by premium commissions.

**Did the introduction of new inducement rules under MiFID II have an effect on the market for investment research?**

That is the key question market professionals have been grappling with ever since MiFID II was implemented in January 2018.

**CFA Institute has endeavoured to determine if its membership in the European Union had a professional opinion on this question by way of two membership surveys which took place successively, first in 2017 (just before the introduction of the new rules) and then**

[1] See Micha Bender, Benjamin Clapham, Peter Gomber & Jascha-Alexander Koch (2021): *To Bundle or Not to Bundle? A Review of Soft Commissions and Research Unbundling*, Financial Analysts Journal, DOI: 10.1080/0015198X.2021.1929687, https://www.tandfonline.com/doi/full/10.1080/0015198X.2021.1929687

**one year after the implementation, in December 2018**[2]. Key results after the second survey included:

- Contrary to the intention of MiFID II, the introduction of the new inducement rules related to payment for investment research did not benefit independent research. A majority of respondents reported sourcing less research from investment banks than before MiFID II. Most respondents also mentioned a reduction in sell-side analyst jobs.

- Research budgets have been scaled back, with the largest firms making the biggest budget reductions.

- Most buy-side professionals believed that research quality was unchanged, but sell-side respondents were in general more pessimistic on this question. A plurality of sell-side respondents believed the research quality of small and mid-cap stocks had decreased.

- A plurality of buy-side respondents and a majority of sell-side respondents believed the research coverage of small and mid-cap stocks had decreased.

- Overall, a plurality of respondents recognised the market for investment research had become more competitive as a result of MiFID II.

In turn, the aforementioned Financial Analysts Journal article, “To Bundle or Not to Bundle?”, has also conducted a review of research papers that have analysed empirically (all used reputable data sources including I/B/E/S, CRSP, FactSet or Datastream) the potential effect of MiFID II’s unbundling rules, using a meta-analysis approach. **Four papers were analysed and dissected according to four underlying dimensions: overall research coverage, specific effects on research coverage of SMEs, impact on quality of research and the information environment’s overall effect before and after MiFID II.**

The key conclusions regarding the effects from MiFID II were:

- All four papers found a significant reduction in analyst coverage of MiFID II-affected firms and therefore of the overall quantity of research available. However, whereas one of the four papers concluded in a loss in coverage for small companies, two conversely observed that loss of analyst coverage was mainly concentrated in medium and large firms. In addition, the observed effect on coverage was most significant for firms that were the largest, older, less volatile and had already greater analyst coverage. In other words, one way to interpret this result is that the introduction of competition has rooted out inferior-quality research and reduced over-supply in some areas.

[2] See CFA Institute, *MiFID II: One Year On*, 2019, https://www.cfainstitute.org/research/survey-reports/mifid-II-one-year-on

- All four papers consistently found increased quality of analysts' research papers following MiFID II introduction. Their observation was that remaining analysts, on average, covered fewer firms and released fewer research reports, therefore putting more effort into their analysis.

- One particularly interesting observation on quality concerns the agency conflict previously mentioned. The papers analysed concluded that remaining analysts tended to issue fewer "buy" recommendations. This could indicate a reduction in bias and the resulting "churning" effect of excessive trading incentives.

- The papers confirmed a tendency for European investment firms to internalise their research effort through an increased number of buy-side analysts. If this trend materialises or further crystallises, it could nonetheless cause structural changes to the dissemination of information across markets, which could have implications for the formation of the Capital Markets Union in the EU.