QUOTED COMPANIES ALLIANCE

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Ms. Rachel Kent
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HM Treasury
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Monday 24 April 2023

Dear Ms. Kent,

Call for Evidence – UK Investment Research Review

We welcome the opportunity to respond to your call for evidence on the UK Investment Research Review.

The Quoted Companies Alliance *Primary Markets Expert Group* and *Secondary Markets Expert Group* has examined the proposals and advised on this response from the viewpoint of small and mid-sized quoted companies. A list of Expert Group members can be found in Appendix A.

The lack of investment research in the UK, both in terms of quantity and quality, has been a longstanding concern of the QCA's, and is a contributory factor in the decline of our markets in recent years. The provision of quality investment research is important for all companies in helping to lower the costs of raising capital and stimulating liquidity. However, it is especially important for smaller quoted companies whose nature dictates that research coverage is one of the only realistic and affordable means by which they can increase their visibility to the market.

The provision of investment research in the UK has been on a downward spiral for many years, which has been exacerbated further with the implementation of MiFID II in January 2018. Since coming into effect, MiFID II has exacerbated the reduction in both the quantity and quality of investment research. We believe that this is particularly the case for research on small and mid-cap securities, which has, as a result, had an adverse impact on liquidity within these securities.

Investment research on small and mid-size quoted companies is essential for increasing visibility and stimulating trading in their shares. Research eases price discovery and enhances liquidity, which in turn reduces the cost of capital for companies and encourages their growth.

This viewpoint is reiterated by investors and companies alike who have a particularly negative perception of the effects of MiFID II on the small and mid-cap segment of the market. Following the implementation of MiFID II, we tracked investors' views towards MiFID II and found that the percentage of investors that believe that MiFID II has had a negative impact on liquidity for small and mid-cap stocks has grown from 54 per cent in 2018[1], to 63 per cent in 2019[2], to 79 per cent in 2020[3]. As a result of MiFID II, less research is being produced. A study by the European Securities and Markets Authority (ESMA) during 2017-2019 found that the number of research reports produced on small and mid-caps had declined by 19 per cent in the first year after the implementation of MiFID II[4]. A similar study conducted by the CFA Institute in 2019 found that the unbundling of research fees had led to a decrease in research coverage for small and mid-caps, with 70 per cent of respondents indicating that they believed it had declined[5]. This, combined with there being fewer brokers participating in the small-cap segment of the market, has led to lower liquidity, greater share price volatility and higher-bid offer spreads. This has resulted in increased costs associated with raising finance coupled with reduced institutional and retail investor appetite for the financial instruments of small and mid-sized quoted companies.

It is commonly believed that this lack of appetite is attributable to the visibility deficit which has been imposed on these companies. The visibility deficit has intensified due to the implementation of MiFID II, which has, correspondingly, led to insufficient research coverage in the smaller quoted company space.

As a consequence of the visibility deficit, investors are either unaware of the potential investment opportunities, or simply unable to access the requisite level of information to make a well-informed investment decision in smaller quoted companies. In this event, smaller quoted companies frequently find themselves outside of the scope of investors' decision-making.

If you would like to discuss our response in more detail, please do not hesitate to contact us.

Yours sincerely,

James Ashton.

James Ashton
Chief Executive

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[1] QCA/Peel Hunt, 2018, Mid and Small-Cap Survey: The New World of MiFID II, available at: https://www.theqca.com/article_assets/articledir_286/143186/QCA_Peel_Hunt_Mid_and_Small-Cap_Investor_Survey_2018_Email%201.pdf

[2] QCA/Peel Hunt, 2019, Mid and Small-Cap Survey: The Search For Research, available at: https://www.theqca.com/article_assets/articledir_356/178156/QCA-Peel_Hunt_Investor_Survey_2019_Report.pdf

[3] QCA/Peel Hunt, 2020, Mid and Small-Cap Survey: To Be Or Not To Be A Public Company – The Growing De-equitisation Crisis, available at: https://www.theqca.com/article_assets/articledir_395/197511/To_Be_or_Not_To_Be_QCA_PeelHunt_Survey_Booklet_2020.pdf

[4] ESMA, 2020, MiFID II Research Unbundling – First Evidence, available at: https://www.esma.europa.eu/sites/default/files/trv_2020_2-mifid_ii_research_unbundling_first_evidence.pdf

[5] CFA Institute, 2019, MiFID II Research Unbundling: A Survey Yielding Mixed Results, available at: https://blogs.cfainstitute.org/marketintegrity/2019/03/20/mifid-ii-research-unbundling-a-survey-yielding-mixed-results/

Q1 How does investment research provision in the UK compare, or how is it perceived to compare, with other major international financial services centres?

Broadly speaking, investment research provision in the UK is similar to many other major international financial services centres. Research provision has generally been poor in most other major jurisdictions for some time, particularly across Europe.

In the US, there is a slightly higher and more extensive degree of research produced than in the UK. While there is little independent research produced, there are higher levels of issuer sponsored research and there are many more analysts per traded security than in the UK.

The accessibility of research in the UK is also more limited than in some other jurisdictions (and we address this in our answer to Q2 below). For example, NASDAQ's website collates analysts' consensus recommendations and earnings forecasts which is a useful tool for investors[6].

However, while the UK now finds itself in a similar position to many other jurisdictions, it was previously in a position of relative superiority compared to its counterparts. Investment research in the UK has been on the decline for multiple years, but MiFID II has exacerbated the lack of provision further. On AIM, for instance, the average company now has between one and two analysts (including the company's retained Nomad/broker). Restrictions in distribution due to other legislation as discussed in our response to Q12 means there are further limitations to ensuring there is an equality of information made available to all investors.

Q2 What is your assessment of the amount, quality and type of investment research currently provided on companies that are listed or quoted, or seeking to be listed or quoted, on the UK public markets?

- **Has that position changed since 2014 (when the UK took steps regarding the use of dealing commission) (or earlier) or 2018 (when the MiFID II unbundling rules came into effect)?**
- **If you are aware of particular differences relating to specific sectors (e.g. technology and/or life sciences), please provide further details.**
- **If you are aware of particular differences with other jurisdictions, please provide further details.**

Firstly, regarding investment research provision, it is important to recognise the distinction between the provision of research and the actual availability and accessibility of that research. That is, whilst some research may be provided, it might only be made available to a limited number of people, thus minimising its potentially positive impact. This is particularly true where research cannot be categorised as an acceptable minor non-monetary benefit (an "AMNMB") in accordance with the FCA's Inducement Rules.

Regardless of this, there is a distinct lack of research provision across UK markets. The primary issue around there being a lack of research provision is due to the difficulties broking firms have with monetising research and the lack of payment mechanisms for it. Lower levels of commission (both in terms of the rates for individual trades and from lower levels of secondary trading) has resulted in less appetite to produce research, and then the implementation of MiFID II and the subsequent best execution mechanism further exacerbated the decreases in commission on secondary trading. Best execution dried up secondary trading for brokers, meaning that they no longer had the same volume of trades, and as a result, the demand for

[6] See here: https://www.nasdaq.com/market-activity/quotes/analyst-research

research depleted. Very few analysts will write independent and unconnected research on companies that are not clients because it is not commercially viable for them to do so. As a result of this, many brokers re-invented their business models by scaling back trading desks and limiting research budgets, leading to market contraction.

As a result of sell-side firms scaling back research capabilities, many experienced and rated analysts left, taking up positions within the buy-side community or leaving the industry altogether. Accordingly, the quality of investment research has also decreased considerably in recent years. There are now significantly fewer brokers and analysts operating in the market then there were previously. There have been arguments made previously that companies are still typically covered by the same number of brokers. However, this is misleading as there are now fewer analysts who individually cover more companies, which has had a significant impact on the quality of investment research. For instance, much of the research produced nowadays simply repeats what the company has already said and there is limited new information, objective analysis, forecasting and recommendations. It is not uncommon for research to simply provide commentary on the company's trading as opposed to setting out what its expected market performance might be. This means that many retail investors, in particular, have no idea what the expectations of the company are.

Q3 How important is investment research to the attractiveness of the UK public markets to listed companies (or companies considering listing) and their investors or to companies looking to access capital in private markets? - Is there a specific link between research and valuations for listed companies or those seeking to list?

Investment research is hugely important to the attractiveness of the UK's public markets for both companies and investors. It is estimated that, of the 1,900 or so companies currently listed or quoted on UK exchanges, approximately half of these do not have any research produced on them at all, and this has significantly impacted the attractiveness of the UK's markets.

For companies, investment research produces the following benefits:

- It increases their visibility, which is particularly important for smaller quoted companies;
- It helps with price discovery and the articulation of the investment case;
- It helps to reduce share price volatility and bid-offer spreads;
- It reduces the costs associated with raising finance;
- It encourages greater levels of institutional and retail appetite for the financial instruments of a company; and
- It can contribute to improved levels of liquidity.

For investors, investment research produces the following benefits:

- It enhances their abilities to develop a deeper understanding of the company;
- It helps them be able to forecast about the companies future prospects;
- It provides an external validation mechanism;
- It allows them to compare peer-group companies more accurately within the market; and
- It assists with their decision-making processes.

We also consider that it is very likely that there is a link between the availability and quality of research with valuations for listed companies. We are also aware of academic evidence that supports this line of thinking[7]. In the cases of AIM and Aquis, research is critical to potential investors' valuations of companies admitted to trading or seeking admission to trading. In the latter case, it is near impossible to persuade institutional investors to support an IPO without at least one analyst producing pre-IPO research.

Q4 Are there specific issues relevant to UK investment research on technology and life sciences companies that should be addressed, including compared to other jurisdictions?

We do not consider that there are specific issues relevant to UK investment research on technology and life sciences companies that should be addressed. We consider that most companies find themselves within a similar position in relation to the lack of investment research, regardless of their sector although we would note that for pre-revenue generating, R&D companies such as those within the life sciences sector, the ability for an analyst, connected or otherwise, to provide colour on the sector and the company's activities and put forward the investment case outside of what can otherwise be sterile company announcements is all the more important.

We do, however, note that, in the US, for instance, there is a much deeper pool of technology and life sciences companies. Naturally, this means that more research is produced on these types of companies, with more research to compare and more people who understand these particular sectors. The dearth of technology companies in the UK makes for a situation where there is naturally less research to use and compare.

Q5 Are there specific issues relevant to UK investment research on smaller UK listed or quoted companies that should be addressed?

- **What counts as "smaller" for these purposes?**

Yes – there are specific issues relevant to investment research on smaller quoted companies that should be addressed. The key issue is around the lack of commerciality for producing research on smaller companies, and as a result of this, research is only produced on these companies by their own brokers. There is no commercial incentive to otherwise produce research on many smaller quoted companies.

Furthermore, trading in smaller quoted companies is dominated by the retail investor community and current rules governing the production and distribution of investment research make it very difficult and expensive for brokers to produce and distribute research to retail investors. Please see our response to Q12 for our ideas on a potential solution to this issue.

Q6 What demand do investors have for research on UK listed and quoted companies, what are the factors driving this demand, and is the amount, quality and type of investment research currently provided sufficient to meet this demand?

In general, we consider that investors will always have a strong demand for high-quality investment research, and we do not consider that the volume and quality of research currently provided is sufficient to meet this demand. There is significant investor demand for research on AIM-quoted companies, both from retail

[7] Trueman, Brett, 1996, the Impact of Analyst Following on Stock Prices and the Implications for Firms' Disclosure Policies, Volume 11, Number 3, Journal of Accounting, Auditing and Finance

investors, who dominate trading in the secondary market (by number of trades) and institutions, which tend to dominate investment in AIM IPOs and secondary fund-raises.

The factors driving demand for research from both types of investors are similar and often relate to:

- The need for factual information on a company and objective analysis capable of substantiation;
- Helping to establish a view of a company's valuation;
- Gathering opinions as to the prospects of the company and its sector; and
- Helping with decision-making through a trading recommendation.

Of course, it must be noted that different types of investors have different priorities and different levels of demands dependent on their own organisational make-up. For instance, some investors have an in-house team of analysts, and therefore do not have as much of a desire to see additional research. However, on the whole, we would consider that investors very much value investment research and have a demand for analysis that is different and thought-provoking.

It is also important to note that an investors desire for research has been forcibly reduced as a result of the implementation of MiFID II. MiFID II has resulted in the breakdown of the relationship and engagement between professional investors and brokers because buy-side investment firms do not want to get charged or have to pay for the engagement where their research budgets have not foreseen it. MiFID II has actively discouraged the interaction between investors and brokers and made it difficult to establish a consensus on what is and what is not an AMNMB, with notable decreases in the sharing of research as well.

Q7 What impact does the current UK legislative and regulatory environment have on the provision and quality of research, including (but not limited to) the MiFID II unbundling rules? Please provide references to relevant legislative/regulatory provisions with your answer where relevant.

The current UK legislative and regulatory framework has had a negative impact on the provision and quality of research, particularly in relation to MiFID II and the unbundling rules. As a result of MiFID II, the level of access to research has changed significantly and market participants are now unable to gain access to every broker's research. This limits the ability of investors to reach a consensus on the share price, making it difficult to determine what any movements are likely to be and resulting in there being a relative lack of transparency within the market.

The unbundling rules, combined with the FCA's continued pressure on asset managers to better manage liquidity and cut the amount of commission paid out of their clients' funds for research services, has resulted in significantly lower commission income for brokers, reducing the amount of money available to support the production of investment research.

Furthermore, the charging structure adopted by many firms with the implementation of MiFID II (i.e. a nominal fee to ensure no immediate breach of the FCA Inducement Rules with a true-up at the end of any relevant period) also makes it difficult because investors are unclear as to whether and to what extent they will get charged by the broker. Again, this causes a breakdown in the level of interaction between the investor and brokers as even though some written material might be capable of being considered an AMNMB, additional discussions with the analyst were considered material and therefore subject to a fee.

Finally, brokers are also unclear on what they can make available to retail investors as a result of how to interpret and apply the regulatory requirements for research intended for retail investors. This means that many brokers tend to ignore the retail investor community in order to avoid any regulatory issues. Consequently, the segment of the market which companies are reliant on to generate liquidity, is hindered due to the lack of research provision for it.

As noted in our response to Q1, NASDAQ's website collates analysts' consensus recommendations and earnings forecasts, but there is no equivalent centralised location for UK companies. Furthermore, we are aware that companies are frustrated in their efforts to individually provide such consensus where they have only a single analyst and that research is not labelled for retail investors. As we have noted, many AIM companies are only covered by one analyst.

Q8 Have the UK 2022 revisions to the MiFID unbundling rules applicable to smaller quoted companies helped to facilitate investment research in relation to those companies?

- **Have these revisions made it more likely that research firms will undertake research on smaller quoted companies?**
- **Is the £200 million market capitalisation threshold appropriate? If not, do you think that a size threshold is the most appropriate tool to incentivise research in smaller companies? If so, what should the level of the threshold be?**
- **For UK firms also operating in the EU, does divergence between UK/EU thresholds have an impact (for example affecting where they decide to do business)?**

On the whole, we do not consider that the 2022 revisions to the MiFID II unbundling rules applicable to smaller quoted companies have helped to facilitate investment research in smaller quoted companies.

Firstly, we do not consider that the £200 million threshold was set at the right level as there is a significant number of small companies above this threshold that do not get much research produced on them. However, it is likely that a higher threshold would also not have the intended impact of facilitating a greater level of investment research. The issue is that once something is established in regulation, organisations commit significant human and financial resource to developing the necessary systems, processes and business models to enable compliance with the regulation. These are then inherently difficult to reverse once implemented.

Furthermore, unless a broker is retained to provide corporate advice and/or broking activities, it is not likely to be commercially viable to produce research on these types of companies as a result of a reduction in trading commission. This is due to, among other things, the FCA pressurising asset managers to cut the amount of trading commission paid to brokers out of their clients' funds. In this environment, it is incredibly difficult to expect more research to be produced.

Q9 What might be the impact of any changes on the proposed UK legislative and regulatory environment on the provision and quality of research, the management of conflicts and payment for the provision of research?

As highlighted above in our response to Q8, making changes to the existing legislative and regulatory environment is likely to have a minimal impact on the provision and quality of investment research. This is because organisations develop the systems, processes and business models to be able to operate under the regulation and any retrospective action to reverse the regulation is often too late.

Q10 Are there impediments (actual or perceived) to dialogue between UK listed or quoted companies and investment analysts that impinge the quality of research that should be considered and addressed?

Overall, we do not consider that there are any significant impediments to a dialogue between UK quoted companies and investment analysts.

However, we do note that the UK version of the EU Market Abuse Regulation (MAR), and the interpretation of its inside information provisions do create complications that restrict the dialogue between quoted companies and investment analysts. This affects the quality and timeliness of information flow from an issuer to its analyst(s), which impinges upon the quality of research produced.

Q11 Are there other impediments (actual or perceived) on the provision of research to investors – whether institutional or private – that should be considered and addressed?

Yes, in addition to our thoughts highlighted above, the Financial Promotions regime and certain aspects of the Consumer Duty inhibit the distribution of research to retail investors.

Q12 What steps (legislative and non-legislative) could be taken to improve the provision and quality of research on UK listed and quoted companies?

- **Please identify any advantages/ disadvantages and overall impact associated with any step you suggest**

As highlighted above in our answer to Q8, we do not consider that the £200 million exemption threshold is set at an appropriate level as there is a significant number of smaller companies above this level that do not have much, if any, research produced on them. However, and while we would not be opposed to increasing the threshold, we do not believe, for the reasons set out above, that changing it would have an overly meaningful impact on the quantity and quality of research produced. We, therefore, urge this Review to consider other means of improving investment research in the UK.

In terms of the steps that could be taken to improve the provision, access and quality of investment research on UK quoted companies, we have the following suggestions:

Establish a mechanism for exchange-sponsored research

The UK should seek to establish a mechanism for exchange-sponsored research. Exchange-sponsored research is used (or has been used) in many jurisdictions across the world, such as in Germany, New Zealand and Israel, and will help to produce further levels of research on companies that might not ordinarily have research produced on them, such as small and mid-caps.

We do not believe, however, that the cost of this should fall on the companies. The cost of being a public company is already considerably high, with these costs being a contributory factor in the de-equitisation trend currently impacting our markets. Placing further costs on companies and forcing them to divert their limited resources elsewhere could be troubling for many small and mid-sized quoted companies. In this light, we propose that the market operator/exchange should be required to fund one piece of research per year for each company on its market.

If, however, companies are charged, such as through part of their listing/admission fee, we believe that this should be proportionate to the size of company.

Acknowledge the role and importance of sponsored research by establishing a Code of Conduct

The UK should follow in the footsteps of the French market and establish a Code of Conduct for sponsored research. This would help to ensure that sponsored research is placed on a proper footing and would boost its validity and reliability. The Code of Conduct would determine how sponsored research is issued and regulated, and could cover issues such as frontrunning, payments, publication and other arrangements. This would alleviate some of the uncertainties around sponsored research and increase levels of confidence in this type of research.

Rightly or wrongly, there is a generally held belief that independent investment research is more valued than sponsored (non-independent) research. This has been supported by research the QCA conducted in 2021, which highlighted that more independent research would raise investor interest in small and mid-cap companies[8]. However, there are inherent issues with independent investment research in that there is very limited commercial incentive to produce such research.

Sponsored research is still very much valued by the investment community, but ensuring that it is subject to a regulators Code of Conduct would place it on a proper footing and boost the recognition and acceptance of sponsored research. At a minimum, the Code of Conduct could cover the following:

1. Author qualification
2. PA dealing rules and frontrunning
3. Contract terms (e.g. fixed sum payment)
4. Quality assurance (e.g. ensuring a balanced report)
5. Editing and governance
6. Sign-off and publication.

Relax the Financial Promotion rules

The UK should seek to relax the Financial Promotion rules that currently inhibit the distribution of small and mid-cap research to retail investors. This would help to ensure more visibility for smaller quoted companies, as well as allow retail investors access to quality investment research so they can make more informed decisions.

The impact of MiFID II, along with the Financial Promotion Rules, on the corporate finance/analyst regime has resulted in a lack of availability of quality research for retail investors. This, in turn, has acted as an impediment to retail investor activity in small and mid-sized quoted company equities. Retail investors are key to stimulating liquidity and facilitating proper price formation in smaller companies who do not have the same level of interest amongst institutions. These companies are therefore reliant on liquidity being generated by retail investors trading in their stocks, but it is extremely difficult and expensive to produce research on such securities to the standards demanded by the FCA's Financial Promotion Rules applicable to research for distribution to retail investors.

In the absence of this research, retail investors have to rely on other, lesser informed sources of information often unsubstantiated and circulated in an unregulated fashion, which runs contrary to the

[8] QCA/Peel Hunt, 2021, Mid and Small-Cap Survey: Unlocking Growth After Lockdown, available at: https://www.theqca.com/article_assets/articledir_524/262051/qca_peel%20hunt%20mid%20and%20small-cap%20survey%202021_asset_604745b8a7272.pdf

FCA's objectives of delivering investor protections. It can quite easily be argued that retail investors are the most in need of high-quality, timely research, but they are the ones who have the most difficulty accessing it.

The absence of detailed research from regulated sources also fuels the rise of "tipsters" and financial journalists who do not have the same level of expertise or knowledge as brokers and analysts, but are relied upon by retail investors as key sources of information.

Access to investment research for retail investors will provide them with better quality information, allowing them to make better informed and more accurate decisions. In order to encourage and promote retail investment at IPO and secondary fundraisings for smaller quoted companies, granting retail investors access to research should be a priority.

Change how brokers charge for research

Currently, many brokers will only make research available when it is paid for by the end-user, meaning that its distribution is often quite limited. If, instead, brokers were only permitted to charge corporate clients for writing research if that research is freely available to all, this would help significantly with the dissemination of research. This means that companies who are paying a broker for research (either through a specific research coverage fee or as part of the broking fee) know that they will be receiving a fully useable product. If the broker considers that research is better monetised through selling research to end-users, this is made transparent to corporate clients and the broking fee should be reduced to allow corporate clients to obtain independent third-party research.

We are aware that this might be a controversial proposal, but believe that there is a conversation to be had about how brokers can improve the dissemination of their research.

Appendix A

The Quoted Companies Alliance *Primary Markets Expert Group*

Samantha Harrison (Chair)	Grant Thornton UK LLP
Azhic Basirov (Deputy Chair)	Global Alliance Partners Financial Limited
Colin Aaronson	Grant Thornton UK LLP
Stuart Andrews	finnCap PLC
Mark Brady	Spark Advisory Partners Limited
Andrew Buchanan	Peel Hunt LLP
David Coffman	Novum Securities Limited
Richard Crawley	Liberum Capital Ltd
Dru Danford	Liberum Capital Ltd
David Foreman	Zeus Capital
Chris Hardie	W.H. Ireland Group PLC
Stephen Keys	Cenkos Securities PLC
Nick McCarthy	Shoosmiths LLP
Katy Mitchell	W.H. Ireland PLC
Hayley Mullens	Radnor Capital Partners Limited
Nick Naylor	Allenby Capital
Jeremy Osler	Cenkos Securities PLC
Niall Pearson	Hybridan LLP
Mark Percy	Shore Capital Group Ltd
Oliver Pilkington	Shoosmiths LLP
George Sellar	Peel Hunt LLP
Paul Shackleton	Peel Hunt LLP
James Spinney	Strand Hanson
Stewart Wallace	Stifel
David Worlidge	Allenby Capital

The Quoted Companies Alliance *Secondary Markets Expert Group*

Mark Tubby (Chair)	finnCap PLC
Amber Wood (Deputy Chair)	Cenkos Securities Plc
Jasper Berry	W.H. Ireland
Andrew Collins	Charles Russell Speechlys LLP
Sunil Dhall	Peel Hunt LLP
Nick Dilworth	Winterflood Securities Ltd
Fraser Elms	Herald Investment Management Ltd
William Garner	Charles Russell Speechlys

Jon Gerty	Peel Hunt LLP
Mitchell Gibb	Stifel
Keith Hiscock	Hardman & Co.
Sacha Morris	Hybridan LLP
Jeremy Phillips	CMS
Katie Potts	Herald Investment Management
Simon Rafferty	Winterflood Securities Ltd
James Stapleton	Winterflood Securities Ltd
Stephen Streater	Blackbird PLC
Peter Swabey	Corporate Governance Institute