17 February 2025
ESMA24-229244789-5256

Securities and Markets Stakeholder Group

Advice to ESMA

SMSG advice to ESMA on its Consultation Paper Draft Technical Advice to the European Commission on the amendments to the research provisions in the MiFID II Delegated Directive in the context of the Listing Act

1 Executive Summary

The implementation of MiFID II in 2018 introduced significant changes to the financial research landscape by mandating the unbundling of research costs from trading execution fees. This regulatory reform was designed to enhance transparency, mitigate conflicts of interest, and improve market efficiency. However, its impacts on market dynamics, information production, and investor outcomes have been both significant and complex. This advice consists primarily of a summary of the findings from academic studies on research provisions in MiFID II.

In the frame of MiFID II provisions to reinforce investor protection, one of the Delegated Directive's objectives was to address the opacity of bundled payments, which was believed to have incentivized excessive trading and potentially created agency conflicts. By requiring explicit pricing for research services, the regulation succeeded in fostering competition and improving the quality of research. The academic studies indicate *significant enhancements in forecast accuracy and the provision of more detailed analyses*, particularly for firms that retained coverage. Despite these improvements, the regulation prompted *a reduction in the overall quantity of research, especially for large- and mid-cap firms, while SME coverage* *remained relatively stable*. This decline in research production may have corrected pre-existing inefficiencies, such as the overproduction of reports on widely followed stocks.

The changes have to some extent also reshaped analyst behavior and the sell-side research market. Analysts *faced increased workloads and "juniorization"* as experienced professionals exited due to reduced profitability. Firms responded by *intensifying their investor relations efforts*, hosting more detailed earnings calls and enhancing direct engagement with investors.

The regulation's effects on market performance were mixed. Price informativeness improved for stocks with retained coverage, as reflected in reduced synchronicity with market-wide movements. However, liquidity impacts varied, with smaller firms experiencing challenges while larger firms saw occasional improvements. Fund performance showed limited direct benefits from increased cost transparency, with some funds reallocating expenses without significant gains for investors.

In conclusion, MiFID II has redefined the financial research ecosystem by enhancing quality and transparency while reducing the scale of research production. The trade-offs between quality and quantity underscore the need for further research into hybrid pricing models and long-term impacts, particularly for SMEs. The challenge ahead is to navigate these complexities to ensure that regulatory frameworks continue to support efficient and equitable financial markets.

2 Background

Article 24(9a) of MiFID II and Article 13 of the MiFID II Delegated Directive set out the conditions that the provision of research by third parties to investment firms must meet in order not to be regarded as an inducement.

Directive (EU) 2021/338 amended MiFID II by, inter alia, inserting a new paragraph (9a) into Article 24. This amendment introduced the possibility for joint payments of execution services and research covering issuers whose market capitalisation did not exceed EUR 1 billion.

The Listing Act provides that joint payments for execution services and research will be made possible irrespective of the market capitalisation of the issuers covered by the research. But whatever payment option an investment firm may choose in relation to its payments for research (out of its own resources, payments from a separate research payment account or joint payments for research and execution services), it will need to adhere to certain conditions so that the provision of research is not regarded as an inducement.

ESMA proposes to include some high-level requirements in Article 13 of the MIFID II Delegated Directive to better align the level 2 legislation with the new options offered in the level 1 text and promote the market for investment research, in a context that continues to regulate inducements and require the proper management of conflicts of interests.

The proposed changes to Article 13 of the MIFID II Delegated Directive (EU) 2017/593 are included in Annex IV of the consultation paper.

The proposed changes include:

- The introduction of new paragraph 1b in Article 13 of the MIFID II Delegated Directive dealing with the annual assessment provided in new Article 24(9a)(c) of MiFID II.
- A new paragraph 10 in Article 13 of the MIFID II Delegated Directive that specifically deals with joint payments for execution services and research and clarifies how firms will meet the conditions for the mandatory agreement between the investment firm and the third-party provider in new Article 24(9a)(a) of MiFID II.

3 The Effects of Research Unbundling (Academic Evidence)

The introduction of MiFID II in 2018 marked a significant regulatory shift in financial markets, particularly through the unbundling of research costs from trading execution fees. This reform aimed to enhance transparency in research pricing, mitigate conflicts of interest (hidden costs, excessive trading incentives) and address concerns about overproduction or low-quality research. The following analysis synthesizes findings from recent academic literature to assess the regulation's impact on market dynamics, information production, and broader financial ecosystems.

3.1 Theoretical Foundations

MiFID II's unbundling provision was rooted in the premise that bundled payments for research and execution services fostered opacity and potentially incentivized excessive trading, often to the detriment of end-investors. Historically, the practice of soft commissions allowed investment managers to indirectly fund sell-side research through trading commissions, creating inherent agency conflicts. By mandating explicit pricing for research services, MiFID II sought to address these conflicts while fostering greater competition and efficiency in the market for financial research (Fang et al., 2020; Guo & Mota, 2021).

A central goal of the Delegated Directive was to improve transparency in research valuation[1] and prevent cross-subsidization practices. However, the literature highlights that the regulation's broader impacts—both intended and unintended—extend beyond these initial objectives.

3.2 Impact on Analyst Coverage and Research Quantity

The implementation of MiFID II precipitated a decline in analyst coverage, particularly for large- and mid-cap firms. Anselmi and Petrella (2021) observed that this decline aligns with a pre-existing downward trend in the European Union (AMAFI 2018), suggesting that MiFID II's requirements accelerated an ongoing rationalization of the research market. Thus, the

[1] It should be reminded that, when the provisions on inducements were discussed at Level 1, it was never really considered that the provision of research would be in-scope. Prior to the trilogue process between the Commission, the Council and the Parliament, the only version that included the notion of "minor non-monetary benefit" was the one from the Council (June 2013), but it also clearly exempted financial research from the scope of restrictions on such benefits. The explicit targeting of research in ESMA's consultation paper for a delegated directive (in May 2014) came as a surprise for the industry. ESMA's proposal was to mandate unbundling. The issue of the financing of research was one of the most debated in the answers provided by the industry to ESMA Consultation Paper. The pushback was based on formal arguments (the issue was not debated at the political level, the mandate given by the Commission to ESMA did not require any specific measure for financial research, the very short timeframe made it impossible to have a proper impact analysis, etc.) and opportunity arguments, considering the likely unwanted effects on the European financial markets.

quantity of information declined, particularly among larger firms. Analyst coverage dropped by 10-15% for EU firms compared to US counterparts driven by medium and large firms (Lang et al., 2024; Anselmi and Petrella, 2021; Bender et al., 2024), and the number of sell-side analysts decreased for firms that are less important to the sell-side (Fang et al., 2020). Notably, smaller firms were less affected, as evidenced by studies indicating a relatively stable level of research coverage for SMEs (Guo & Mota, 2021; Amzallag et al., 2021).[2] This contrasts with initial fears that small firms would disproportionately lose coverage due to reduced profitability for brokers.

The literature also reveals a nuanced effect on research quantity. While aggregate research production declined, particularly for firms considered less critical to sell-side analysts, this reduction may have mitigated an "overproduction" of research that characterized the pre-MiFID II era. Analysts' focus shifted away from redundant coverage of widely followed stocks, potentially enabling a more efficient allocation of research resources (Lang et al., 2024) and buy-side investment firms turned to more inhouse research after MiFID II implementation (Fang et al., 2020).

3.3 Research Quality and Analyst Behavior

Despite the decline in research quantity, MiFID II appears to have enhanced research quality. Studies by Fang et al. (2020) and Guo and Mota (2021) report improved forecast accuracy and more detailed, substantive analyses in the post-MiFID II environment. This shift is attributed to heightened competition among analysts and the need to justify the value of their research to buy-side clients. Li et al. (2022) further demonstrate that the reduction in analyst coverage contributed to improved price informativeness, as remaining analysts produced higher-quality, firm-specific insights. Regarding Small and Medium Enterprises (SMEs), the primary concern of industry participants, Liu and Yezegel (2020) and Amzallag et al. (2021) point out that MiFID II was effective in separating research and execution

[2] The SMSG notes that the academic papers do not mention the difference between "spontaneous research" (research undertaken by a research provider on its own initiative) and "sponsored research" (research undertaken by a research provider with a full or partial financing by the issuer). This makes it difficult to assess whether the stable level of research relates to spontaneous research only, or to the combination of spontaneous and sponsored research, the mix of which has varied since the implementation of MiFID II.

services and levelling the playing field without significantly hurting the quality of sell-side equity research. They show that the quality of research on SMEs, as indicated by forecast accuracy, did not decline when compared to that of larger firms.

However, the regulation also posed challenges for sell-side analysts. Lourie et al. (2023) and AMF (2020) highlight a phenomenon known as "juniorization," where high-quality analysts—those who were more accurate, experienced, and in senior positions—left the sell-side due to reduced profitability. This shift raised concerns about the erosion of expertise within the industry. Additionally, analysts faced increased workloads, with a notable 11% rise in the number of stocks covered per analyst, according to AMF (2020), potentially diminishing the depth of their research. As a result, analysts adjusted their behaviour, leading to a decrease in the frequency, optimism, and accuracy of forecasts, particularly for stocks with high trading significance (Lourie et al., 2023).

3.4 Corporate Response and Investor Relations

The reduction in sell-side coverage prompted significant changes in corporate communication strategies. Firms, particularly those experiencing a decline in analyst coverage, intensified their investor relations efforts. Lang et al. (2024) and Kim et al. (2023) report increased frequency and detail in earnings calls and analyst days, as firms sought to compensate for the diminished dissemination of sell-side research. Additionally, buy-side analysts became more active in conference calls, asking more questions and engaging more with management, particularly in European firms post-MiFID II, compared to their North American counterparts, according to Fang et al. (2020). The role of Investor Relations Officers (IROs) also expanded, reflecting a shift toward more direct engagement with investors (Abhayawansa et al., 2024). As a result, there was not only a rise in the volume and frequency of two-way communication with investors, but also an increased emphasis on the importance of direct IRO-investor interactions.

3.5 Effects on Market Dynamics and Performance

The literature presents mixed findings regarding MiFID II’s impact on market dynamics.

3.5.1 Price Informativeness

On one hand, Li et al. (2022) highlight improvements in price informativeness, with reduced stock return synchronicity indicating a greater incorporation of firm-specific information into stock prices. Synchronicity decreased more for firms that lost analyst coverage, suggesting the remaining analysts exerted more effort to provide high-quality, firm-specific insights (stock prices incorporate more firm-specific information). On the other hand, Lang et al. (2024) suggest that reduced sell-side coverage led to an overall decline in market informativeness, underscoring a trade-off between quality and quantity in information production. However, reduced analyst coverage did not significantly impair the overall informativeness of stock prices (Anselmi and Petrella, 2021) for large-capitalization stocks and had limited worsening for SMEs.

3.5.2 Liquidity

Liquidity effects were similarly diverse. While several studies report a decline in market liquidity, measured by both bid-ask spreads and the Amihud Ratio, particularly for smaller firms (Fang et al., 2020; Amzallag et al., 2021; Anselmi & Petrella, 2021), other research finds no significant changes (Guo and Mota, 2021) or even improvements for large-cap stocks (Bender et al., 2024). This variability highlights the complex interplay between reduced public research availability, increased private research activity by buy-side firms, and differences in sample periods.

3.5.3 Trading Volume

The trading volume surrounding earnings forecasts has significantly declined (Lourie et al., 2023), and market quality—measured by trading volume and volatility—has decreased for both SMEs and non-SMEs (Bender et al., 2024). These changes may also be attributed to other factors, such as alterations in trading obligations, trade reporting requirements, and the double-volume cap mechanism for dark pools. Despite this, stock prices have become less correlated with systematic market shocks and more reflective of individual company fundamentals, thereby reducing systematic downside risk (Li et al., 2022).

3.6 Implications for Fund Performance and Execution Costs

MiFID II's separation of research and execution costs had limited direct benefits for fund investors. Fröberg and Halling (2024) find no significant improvement in net fund performance or transparency, despite the regulation's emphasis on cost clarity. While some funds reduced their commissions, others increased them, resulting in no significant net effect. [3] High-Active Share funds, characterized by distinct investment strategies, experienced increased expense ratios, possibly due to shifts in cost allocation. The unbundling also prompted cross-subsidization practices, with U.S. funds benefiting from higher bundled commissions, raising questions about regulatory arbitrage (Evans et al., 2024). Evans et al. (2024) show that US funds that had EU counterparts—EU-based funds with the same management team and investment style— increased bundled commissions while the EU twins maintained similar management fees and trading activity. A structural model for the US suggests that if investment managers were required to pay for the research they consume in hard dollars, fees would be 10% higher. However, these changes did not lead to improvements in net fund performance. High-Active Share funds saw an increase in total expense ratios post-unbundling, possibly due to a shift in cost allocations (Fröberg and Halling, 2024). The effect on fund performance remains difficult to disentangle (Evans et al., 2024), with conflicting findings in the US context: some studies suggest a negative impact (Edelen et al., 2006; Haziza and Kalay, 2020), while others report a positive effect (Horan and Johnsen, 2008; Livingston and Zhou, 2015).

3.7 Conclusions

The literature collectively underscores the transformative impact of MiFID II on the financial research ecosystem. By increasing transparency and fostering competition, the regulation

[3] The SMSG notes that this finding contrasts with the feeling expressed by research producers, who tend to indicate that they saw a marked decrease in amounts dedicated to the funding of research. Similarly, some non-academic studies seem to conclude that budgets have decreased regularly after the application of MiFID II, only stabilising in 2022 (Substantive Research's latest survey shows that research budgets rise globally for the first time since MiFID II - Substantive Research).

succeeded in improving research quality and mitigating conflicts of interest. However, these benefits came at the cost of reduced research production and a reshaping of traditional sell-side dynamics. The mixed effects on market liquidity, informativeness, and fund performance highlight the need for deeper assessments of regulatory outcomes.

The value of research has evolved significantly, with buy-side firms becoming more discerning about the research they pay for and many asset managers bolstering in-house research capabilities. There has been a shift from traditional sell-side research to sponsored research for SMEs, although this may raise concerns about conflicts of interest. Moreover, the research landscape is constantly changing due to factors like digitalization, the use of machine-readable data, AI-driven analysis, and increased investor-company relations, which now encompass both financial and sustainability information.

Despite the relaxation of rules for small-cap companies (Directive (EU) 2021/338), most asset managers continued to unbundle research due to the operational complexity of managing two invoicing systems and the dynamic nature of market caps. The regulatory burden on firms remained significant, and post-MiFID II, many asset managers began absorbing research costs directly, though some pass them on transparently through Research Payment Accounts (RPAs) funded by clients. Asset owners, who are accustomed to not paying for research, may face new challenges if they are required to pay separately post-rebundling. Additionally, the impact of the Capital Markets Union (CMU) on the research market and, by extension, on firms' financing, remains an important question for the industry.

Future research should explore the long-term implications of MiFID II, particularly its effects on SMEs and evolving market structures. Hybrid models, such as the current optionality to the user of research to choose between bundled or unbundled ofresearch and execution services, warrant further investigation as potential solutions to balance transparency with access to high-quality research. Policymakers must consider these complexities to refine regulatory frameworks and ensure the sustained efficiency and fairness of financial markets.

3.8 References

1. Abhayawansa, S., Aleksanyan, M., & Lee, K. (2024). Disruption in the market for information: MiFID II and investor relations. *European Accounting Review*, 1-25.
2. Amzallag, A., Guagliano, C., & Lo Passo, V. (2021). *MiFID II research unbundling: Assessing the impact on SMEs*. Working paper, ESMA.
3. Anselmi, G., & Petrella, G. (2021). Regulation and stock market quality: The impact of MiFID II provision on research unbundling. International Review of Financial Analysis, 76.
4. Evans, R. B., Gomez, J. P., & Zambrana, R. (2023). MiFID II Research Unbundling: Cross-border Impact on Asset Managers. *Available at SSRN*.
5. Fang, B., Hope, O. K., Huang, Z., & Moldovan, R. (2020). The effects of MiFID II on sell-side analysts, buy-side analysts, and firms. Review of Accounting Studies, 25(3), 855–902.
6. Fröberg, E., & Halling, M. (2024). Do investors benefit from MiFID II unbundling?. *Journal of Corporate Finance*, 102615.
7. Guo, Y., & Mota, L. (2021). Should information be sold separately? Evidence from MiFID II. Journal of Financial Economics, 142(1), 97–126
8. Kim, C., Park, J., & Sul, E. (2023). The Effects of MiFID II on Voluntary Disclosure. *Available at SSRN 3980230*.
9. Lang, M., Pinto, J., & Sul, E. (2024). MiFID II unbundling and sell-side analyst research. Journal of Accounting and Economics, 77(1)
10. Li, Y., Liu, X., & Pursiainen, V. (2022). Analyst incentives and stock return synchronicity: Evidence from MIFID ii. *Financial Analysts Journal*, *78*(4), 77-97.
11. Liu, Z., & Yezegel, A. (2020). Was MiFID II effective in unbundling execution and research services? https://ssrn.com/abstract=3525201
12. Lourie, B., Shanthikumar, D., & Yoo, I. (2023). MiFID II and the unbundling of analyst research from trading execution. Contemporary Accounting Research, 40(4), 2340–2372. https://doi.org/10.1111/1911-3846.12865

4 SMSG opinions and comments

4.1 Global approach adopted for the proposed amendments to Commission Delegated Directive (EU) 2017/593

The SMSG agrees with the global approach adopted for the proposed amendments to the Delegated Directive, that consists of integrating high level requirements in article 13, as this approach (i) responds to the mandate set by Level 1, (ii) is consistent with the affirmed intention of European authorities to limit and reduce as much as possible the administrative burden for European companies and (iii) keeps a level of flexibility that will be welcome for entities envisaging to use the new payment option for the research they receive.

Considering the impact that changes in the payment modalities may have on the availability and quality of research, as demonstrated above, the SMSG considers that the approach to amend the Delegated Directive should come with an approach aimed at monitoring, *ab initio*:

- the adoption of the joint payment method,
- the evolution of budgets for research on EU underlyings, notably for those entities having adopted the joint payment method,
- the evolution of the availability of non-sponsored research, ideally with a distinction by market cap, and
- the quality of research, as measured through objective indicators (EPS surprises, price informativeness, etc.).

4.2 Annual assessment of the research used

Under the current MiFID II Delegated Directive, an investment firm using a research payment account for the payment of research is required to “regularly assess[..] the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions.”. It is our understanding that ESMA proposes to make this requirement more generic but also more informative, by replacing the current wording by a separate paragraph 1.b. stating that the assessment "shall be based on robust quality criteria and include, where feasible, a comparison with potential alternative research providers.".

However, as currently drafted, the provision potentially also risks introducing some unnecessary regulatory complexity, particularly for smaller firms. Indeed, such a comparison may not always be feasible (for instance due to lack of available comparable research) or the assessment of the quality of the research could be established by means other than a direct comparison with other providers (for instance via rankings published by third parties). Furthermore, it should be considered whether annual review obligation is reasonable for all research providers. In case the research firm covers only few companies or few small markets, an annual review (often without any competitors in the market) would be a formality and unnecessary cost item. The final text should ensure there is sufficient flexibility for these types of situations to be taken into account by supervisory authorities.

4.3 Requirements applicable to the joint payments method

ESMA proposes to introduce a new paragraph 10 in Article 13, stating that: "Where an investment firm pays jointly for execution services and research, Member States shall ensure that the investment firm shall enter in an agreement for joint payments when the methodology for remuneration: (a) prevents that the investment firm would pay substantially more for the research component than the costs of the research when the firm would have paid directly for it; (b) does not impede the firm's ability to comply with the best execution requirements".

The SMSG considers that both criteria are justified (point (b) being a useful reminder of a pre-existing regulatory obligation) and expressed in convenient terms, that avoid being overly prescriptive.

In particular, the SMSG does not believe that any further requirements or conditions applicable to investment research provided by third parties to investment firms should be introduced in the proposed amendments to Commission Delegated Directive

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA’s website.

Adopted on 7 February 2025

[signed]	[signed]
Giovanni Petrella Chair Securities and Markets Stakeholder Group	Ariadna Dumitrescu Rapporteur