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THE EUROPEAN ASSOCIATION OF INDEPENDENT RESEARCH PROVIDERS (EURO IRP) RESPONSE TO ESMA CONSULTATION PAPER REGARDING THE AMENDMENTS TO THE RESEARCH PROVISIONS IN THE MIFID II DELEGATED DIRECTIVE

REFERENCE ESMA35-335435667-5979

CONSULTATION PAPER ON TECHNICAL ADVICE TO THE EUROPEAN COMMISSION ON THE AMENDMENTS TO THE RESEARCH PROVISIONS IN THE MIFID II DELEGATED DIRECTIVE

Question 1: Do you agree with the proposed approach? Or would you prefer a more or less detailed approach? Please state the reasons of your answer.

Answer 1:

Foreword

Euro IRP, as an association of independent research providers across Europe, fully supports the proposed approach and recognizes the critical need to enhance the production of high-quality research within Europe. It is crucial that the amendments to the MiFID II Delegated Directive on research provisions ensure a level playing field that recognizes the value of independent research providers. Independent research is an essential component of a diverse and effective investment ecosystem, offering unique perspectives and enhancing decision-making for asset managers. To sustain the availability and quality of independent research, it is imperative that these providers are adequately compensated for their contributions. Importantly, the framework should ensure that not only brokers with execution desks, but also independent research providers are eligible for fair remuneration. Clear provisions enabling asset managers to engage and pay independent research providers will foster competition, drive innovation, and ultimately benefit end investors by promoting a more dynamic and informed market.

In order to be effective, we highly recommend clear guidelines for this payment option and making sure that there will be no impediment that would cause any research providers (even those without trading facilities) to be excluded from such payment option.

Back to question 1

Simplifying payment mechanisms through the amended Research Payment Accounts (RPAs) represents a positive step forward. However, we believe it is less effective than promoting Commission Sharing Agreements (CSAs) as a means to open financial research markets to new entrants.

While RPAs have faced criticism for their lack of transparency and their contribution to increased rigidity in an already highly regulated industry, CSAs offer a more flexible solution. They facilitate a transition to alternative research suppliers while ensuring adherence to defined budgets.

It is crucial to ensure that research is not utilized as an inducement to trade or to procure other banking services. To prevent conflicts of interest, appropriate levels of disclosure must be implemented. However, these disclosures should not create obstacles to switching between research providers. We are concerned that the emphasis on managing inducement risks appears to have been diminished in the revised text compared to the previous version.

Maintaining the original objectives of MiFID II's unbundling rules—namely, achieving transparency in research costs and minimizing conflicts of interest—remains of paramount importance.

Question 2: Do you agree with the introduction of new paragraph 1b in article 13 of Commission Delegated directive 2017/593? Please explain why.

Answer 2:

We partially concur with the introduction, as assessing research quality is undeniably important. However, this task is inherently challenging due to the absence of universally objective criteria.

Objective Criteria

Metrics such as the performance of ratings (e.g., those tracked by Bloomberg) or the predictive accuracy of future earnings should be integral to any quality assessment framework. Moreover, the availability of research during critical market events—such as during deal-making periods—is essential. Investment banks frequently suspend research coverage during such times, leaving the market without crucial insights. In contrast, independent research providers can maintain uninterrupted coverage, offering a significant advantage that warrants consideration in quality evaluations.

Subjective and Problematic Factors

Some criteria, such as analysts' proximity to a company's senior management, are inherently subjective and may pose challenges. While closer relationships can enhance an analyst's understanding of a firm's strategy, they also introduce risks of biased judgment or preferential access to information.

Similarly, service levels, such as research dissemination through investment bank sales teams, are often tied to marketing efforts rather than the intrinsic quality of the research itself. Marketing-driven distribution, subsidized by commissions or other investment banking revenues, reflects a focus on maintaining trading relationships rather than the actual value of the research.

Key Distinction

To ensure transparency and promote fair competition, it is essential to compare research providers. However, a clear distinction must be made between:

- **Independent research providers:** These are defined as unconnected entities that derive no revenue from investment banking, trading, or corporate services and operate free from conflicts of interest.
- **Broker/investment bank research providers:** These entities often benefit from subsidies provided by their banking, trading, or corporate service divisions, enabling them to sell research below cost. This practice creates unfair competition, distorts the market, and leads to a focus on larger, more tradable stocks.

Recommendation

We strongly recommend that any framework for evaluating research providers explicitly differentiate between independent providers and broker/investment bank providers. This distinction is critical to ensuring transparency, fairness, and a competitive landscape in the research market.

Question 3: If you do not agree with the introduction of new paragraph 1b , please provide alternative suggestions and /or explain how investment firms operating a research payment account currently assess the quality of research purchased ?

Answer 3:

Proposed Framework to Enhance the Evaluation and Fairness of Research Services

To ensure transparency, fairness, and competitiveness in the evaluation of research services, we propose the following framework:

1. Distinction Between Independent Research and Broker/Investment Bank Research

- Clearly define independent research as research produced by firms that do not derive any revenue from investment banking, trading, or corporate services, thereby eliminating conflicts of interest.
- Differentiate independent research from broker/investment bank research, which benefits from subsidies and is inherently exposed to potential conflicts of interest due to ties with issuers and other services.

2. Introduce Objective Metrics for Research Quality Assessment

- Establish a set of mandatory, objective metrics to evaluate research quality, where applicable, such as:
 - **Performance of Ratings:** Measure the accuracy of recommendations, using systems like Bloomberg to track performance.
 - **Availability of Research:** Evaluate the consistency of research availability, particularly during critical market periods (e.g., during corporate deals, market crises, or declining liquidity).
 - **Predictive Quality:** Assess the accuracy of earnings forecasts, particularly as they relate to the fund's holdings over the year.
- Acknowledge that for a substantial portion of research, objective, numerical metrics may not be feasible. We emphasize that subjective assessments remain the cornerstone of investment research and should not be eliminated. However, when objective metrics are available, they should complement subjective evaluations to provide a holistic assessment.

3. Separate Research Dissemination from Quality Assessment

- Clearly distinguish the dissemination of research (e.g., the level of service provided by sales teams) from the intrinsic quality of the research itself.
- Marketing and sales-driven efforts, akin to advertising, should not influence research quality assessments. These elements primarily reflect distribution efficiency rather than the actual substantive value of the research.

4. Exclude Corporate Access from Research Assessment

- Prohibit the inclusion of corporate access in research evaluations to prevent significant conflicts of interest.
 - Issuers often reward brokers who provide favourable research with preferential access to corporate roadshows, creating direct and indirect financial advantages for brokers.
- While corporate access is undoubtedly valuable to asset managers, it must be treated as a separate service and entirely disentangled from research quality evaluations.

Conclusion

This proposed framework ensures that the evaluation of research focuses on transparency, quality, and fairness. By preventing conflicts of interest and maintaining a clear distinction between different services, it fosters a competitive and objective environment for research providers.

Question 4: do you agree that, when conducting the annual assessment provided in new article 24 (9a) of MIFID2, an investment firm could be required to include a comparison with potential alternative research providers ? Please state the reasons for your answer. Please also provide feedback on the availability of free trials for research services and why they may or may not be appropriate for investment firms to fulfill their obligations under Article 24(9a). If free trials are not appropriate, which other methods could be used for comparison?

Answer 4:

1. Comparison of Research Providers

- Comparing alternative research providers is essential to ensure that asset managers access the best research services tailored to their needs.
- A fair comparison framework can only be achieved if corporate access is explicitly excluded from such efforts. Independent research providers do not cater to corporate access, as it offers no intrinsic value. Conversely, investment banks and brokers actively promote corporate access, which is indirectly compensated through increased trading volumes, with the ultimate client often being the corporate issuer itself.
- Discovery mechanisms for evaluating research can be time-consuming and may necessitate external consulting firms to manage the process. While this adds complexity, it ultimately benefits asset managers and end investors by ensuring access to high-quality research.

2. Free Trials for Research

- Free trials provide a practical opportunity for asset managers to sample research and assess its relevance before committing to a subscription.
- In mid-2022, the UK eased dissemination obligations for independent research providers. However, this regulatory change has had little impact on the adoption rates of independent research by asset managers.
- While free trials are valuable, providers must retain the flexibility to terminate them at their discretion.
- There have been suggestions that research offered on free trials could be subject to the same assessment criteria as paid research if the trial period exceeds a specific duration (e.g., six months within a calendar year). Although this approach ensures fair evaluation, it risks discouraging asset managers from exploring new research providers due to the added administrative burden. As such, we view this proposal as counterproductive.
- The independent research community has faced an increase in lengthy free trials that do not lead to subscriptions, with some asset managers exploiting the system to “free ride.” Free trials of more than one to two months are unnecessary for forming an informed opinion about the research. Euro IRP advocates for limiting free trial periods to prevent abuse, including the use of free trials as inducements (discussed below).
- External consulting firms could also play a role in assessing research during free trials, ensuring a fair and unbiased evaluation process.

3. Risk of Inducements

- A significant concern is the potential for research to be offered for free as an inducement to use other services, particularly by banks or brokers.
- The risk of inducement varies significantly between brokers, who often bundle research with broader services like trading and corporate access, and independent research providers, who lack these conflicts of interest.

Conclusion

Free trials remain a valuable method for evaluating research, but safeguards must be in place to prevent their misuse as inducements. Clear guidelines on trial durations and evaluation criteria, alongside a distinction between independent providers and brokers, can foster fair competition and transparency without discouraging asset managers from exploring new research options.

Question 5: Do you agree with the introduction of new paragraph 10 in Article 13 of Commission Delegated Directive (EU) 2017/593? Please state the reasons for your answer.

Answer 5:

Response on Bundling Research and Trading

The possibility to bundle research and trading can provide a valuable mechanism for asset managers.

However, it is imperative that this arrangement does not create any undue advantage for the trading firm involved. To ensure fairness and transparency, research provided by trading firms must adhere to the same rigorous standards as research from other providers. Additionally, the trading fees allocated to the research wallet under the revised Research Payment Account (RPA) framework should be predetermined and accessible for paying all research providers, regardless of their affiliation.

Best Execution

While best execution is a cornerstone of a well-functioning equity market, it remains challenging to accurately assess pre-trade. It should nonetheless be the primary—if not the sole—criterion when selecting a trading firm.

However, it is worth noting that the current interpretation and application of best execution have inadvertently become a barrier to entry for new participants in the trading sector. This lack of competition stifles innovation and indirectly limits the development of a more open and diverse research market.

Clarifications on the Amended RPA

We recommend providing more detailed guidance on the amended RPA framework. To encourage its broader adoption, certain restrictions previously applied to RPAs should be explicitly removed. In particular:

- The requirement for asset managers to hold funds in a dedicated account should be eliminated.
- A return to former practices, where monies were held on the execution broker's account, would simplify the process and increase flexibility for asset managers.

These changes would enable asset managers to work with multiple trading counterparties more easily, thereby facilitating the efficient creation and management of research wallets.

Regulatory Convergence

- It is vital for EU regulations to converge with those of the UK and the US, where financial markets have demonstrated that increased research availability positively impact investment performance.
- Funding research through funds under management should be facilitated, underscoring the need to streamline and encourage the adoption of CSAs.

Question 6: Do you think that any further requirements of conditions applicable to investment research provided by third parties to investment firms should be introduced in the proposed amendments to commission delegated Directive 2017/593? Please state the reasons for your answer.

Answer 6:

Recommendations for Enhanced Guardrails

We believe additional guardrails should be outlined, even if some of these will ultimately fall under Level 2 or Level 3 measures, or the jurisdiction of NCAs. Below are our suggestions:

1. Transparency in Research Allocation

- Given the fundamental differences between independent research and broker/connected research, a breakdown of spending on these categories should be included in the annual research purchase report.
- While we do not advocate for mandatory floors or caps, it is essential for end investors to understand if an asset manager allocates 100% of its research wallet to potentially conflicted research.
- Independent research offers distinct advantages that brokers cannot match, such as the absence of buyer bias, freedom from conflicts of interest, and continuity of coverage.

2. Flexibility in Research Budgets

- Research budgets should be forecasted *ex ante* and funded via RPAs or CSAs.
- If the budget is consumed faster than anticipated (e.g., within six months), mechanisms should allow for seamless extensions to ensure asset managers can continue accessing valued services.

3. Differentiation Between Research Types

- A clear distinction should be made, when applicable, between written research (delivered through generic mailings or websites) and tailored services.
- While such distinctions are often made *ex post*, they should also be priced separately *ex ante*. This approach would enable easier comparison of the written research component across providers, fostering transparency and competition.

Additional Comments on Matters Beyond the Consultation Paper

While these points are not directly addressed in the consultation paper, they are critical to the ongoing review of MiFID II:

Embracing AI in Research

- Recent advancements in AI have led to remarkable developments, enabling the creation of robust investment cases by fully autonomous "robot analysts."
- Regulation should ensure that the productivity gains and enhancements brought about by AI are not monopolized by a select group of regulated players.
- Differentiating between connected research—subject to regulation due to its inherent conflicts—and independent research, which is funded solely through transparent subscriptions and free of conflicts, is crucial. This distinction would encourage healthy competition and foster innovation including through AI.
- Such measures would promote creativity and competitiveness, ensuring that Europe benefits from a more dynamic and open research market.