Liquidnet
Market Structure

Rebundling Unbundling

Full Report

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As we highlighted in Reconstructing Unbundling 2020,[1] access to small and mid-cap research is now seen as an urgent European policy priority given the importance of SMEs for the wider economy and the continued decline of analyst coverage. In the UK alone, small and mid-caps make up 93% of quoted companies, employ three million people and contribute over £26B in tax.[2] Less SME coverage is perceived as leading to lower investment in small and mid-caps, less secondary trading liquidity and ultimately fewer IPO listings across the Union. The theory is that by allowing asset managers to pay for research from trading fees:

- bank analysts will be incentivized to produce research on small and mid-cap companies;
- leading to greater liquidity in small and mid-cap names;
- which will promote more investment in the European economy.

The proposal by the EU Commission to revisit MiFID II rules on unbundling is subject to a further Consultation Paper[3], which raises an important and necessary debate as to whether re-bundling of small and mid-cap research will improve coverage of SMEs.

What is the EC proposing in the Consultation Paper?

The Commission makes two proposals:

Option 1: allowing for an exemption of the current research unbundling requirement if brokerage and research provision pertain to small and mid-cap issuers.

Option 2: improving the availability of small and mid-cap research by establishing a clear set of rules to make both issuer sponsored and exchange sponsored research more reliable and useful for investors.

The EU Commission is in favour of Option 1 which would require:

- Targeted amendments to Article 13 of MiFID II Delegated Directive (EU) 2017/593
- The creation of a narrowly defined exception authorising the joint payment for execution services and research on **small-cap issuers and research on fixed income.**
- Small and mid-cap issuers would be defined as issuers that did not exceed a market capitalization threshold of **EUR 1 billion over a 12 month period.**
- The current requirement to set up a research payment account (RPA) or to issue separate invoices for investment research would not apply.
- However, joint payments would only be allowed in case of an agreement between the investment firm and the research provider on what part of the joint payments are attributable to the provision of investment research.
- The investment firm would be required to inform its clients of the joint payment.

Will Rebundling work?

The crisis has once again highlighted a key issue in Europe—the economy's over-reliance on debt. The European Capital Markets Union (CMU) project is seen as critical to switching companies from relying on bank loans to equity financing. The question is whether

1: https://www.liquidnet.com/expert-insights/esg-the-regulatory-onslaught-begins-2020-zjm9k
2: https://bit.ly/2ZkpP2r
3: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12530-Amendments-to-Delegated-Directive-EU 2017-593-on-the-research-regime-to-help-the-recovery-from-the-COVID-19-pandemic

re-bundling research payments will deliver on this goal, particularly as a number of European asset managers have already stated that they are unlikely to reverse unbundling. In an environment of declining trading volumes and falling commissions, maximizing the best use of available research budget is critical. Unbundling provides the buy side with improved visibility of the services it consumes from the sell-side—research and execution; at what cost and whether these services are worth continuing to pay for, and there is currently little appetite to reverse this level of transparency.

The key challenges are:

1. Operationally re-bundling will be a huge headache for the buy-side. Market caps change daily but research agreements are not dynamic, and the quality of research provision is not assessed at the individual report level but for the overall service. Research analysts are organised by sector not market cap which will also create challenges in how you separate analysts between market cap and payment methods. How the buy side will process updates is another consideration. For Fixed Income research, payments for this asset class research are low although it seems somewhat counter intuitive to have a goal of incentivising the equitization of markets to move away from debt by rebundling research payments for FI research.

"The biggest thing for us has been best ex; it is just starting to show that a lot of trading counterparties aren't investing enough in their platforms, so they are starting to slip and split in terms of delivering us best ex. So although we are still bundled in the US, it is harder to hit commission targets for the bulges if they are not delivering best ex."

Medium-sized US Asset Manager

2. Providing research based on market cap risks impacting delivery of best execution. Traditional research agreements are set up for annual provision of research whereas market cap calculations are dynamic. Linking this to execution could be problematic if commission rates now need to be set according to market cap and could risk incentivising directed orders for certain market cap stocks to increase commission payments.

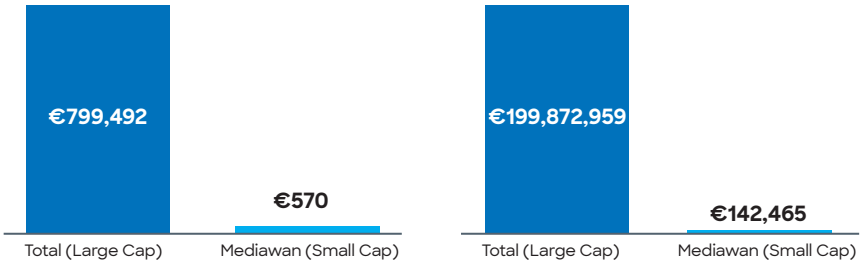
3. Bulge brackets providing both equity and FI research will have to establish how to compensate analysts. This is particularly problematic for corporate bonds where equity research is used heavily. Research departments have set up with the rules in place and would need to make changes to how they structure research and payment schedules—but only for those clients who chose to reverse unbundling, adding to the complexity of charging models.

4. Just 17% of respondents in Liquidnet's outreach attributed the decline in small and mid-cap coverage to MiFID II.[4] In reality analyst coverage by bulge bracket analysts has been in decline for a number of years as it does not pay as well as large cap. Only five percent of companies with a market cap of less than $250M have any research coverage at all. Companies with a market cap between $250M and $1B are more likely to have analyst coverage, with 27% having between one and three covering analysts and 36% having four to six covering analysts. But 17% of these companies still have no analyst coverage at all *(see exhibits 1 and 2)*.

"There is less coverage of the smaller firms/companies, but this lack of coverage is not because of Mifid, the coverage wasn't there to start with."

Head of Trading
Large European Asset Manager

Exhibits 1 and 2
Average daily notional for Total (large cap) and Mediawan (small cap)
Yearly notional for Total (large cap) and Mediawan (small cap)



Source: Bloomberg data, June 18, 2018–June 18, 2019

5. Just 24% of responding firms were still paying for research only using all-you-can-eat models with bulge brackets and Covid-19 is creating an even bigger impact. Physical proximity no longer matters according to Integrity Research,[6] there has been a 44% drop in conferences and a 30% drop in investor days. While CSA brokers first quarter

4: http://bit.ly/2U6Ev45
5: https://www.irmagazine.com/small-cap/company-sponsored-research-gains-credibility-say-experts
6: https://tabbforum.com/opinions/confusion-abounds-regarding-first-half-research-payments/

payments for sell-side increased, independent research was up 40% to 60% according to the same article. There could be two reasons for this: either first half bulge bracket research budgets were capped out due to the higher levels of access; or alternatively, research is being sourced from more specialist providers. The decline in sell-side service and rising juniorisation is moving the buy-side towards hybrid pay-as-you-go models from a broader range of research providers, enabling more flexibility to access what is required when it is needed. Added to which working from home has switched traditional sell-side analyst meetings from an hourly visit to a 15-minute Zoom call, arguably giving the buy-side more purchasing power in how they choose to engage their sell-side brokers. COVID has shown that there is a massive body of knowledge and data that resides outside of banks. This could offer an opportunity for the sell-side to focus more on using external researchers, manage their cost base more effectively and access to broader networks of insights.

6. Research as a product is changing: 61% of respondents have increased their use of preformatted, machine-readable data in the investment process; 86% increased their use of ESG data and three-quarters of respondents are contacting companies direct.[7] Rather than traditional bulge brackets being the providers of this research, increasingly asset managers are using third-party data specialists or even going to the companies direct themselves. Incidents such as Wirecard[8] emphasises the need not only for access to research analysts but also the ability to interrogate the information received and conduct internal due diligence, rather than relying on analyst recommendations alone.

So what IS included in the SPV?

The focus is on supporting the recovery plan for Europe, including measures that aim at kick-starting the economy and helping private investment given the perceived challenges with liquidity and access to finance.

Amendments to information requirements:

1. Phase-out of the paper-based default method for communication
2. Costs and charges disclosure: Introduction of an exemption for eligible counterparties and for professional clients
3. Reduction in ex-post reporting requirements
4. Suspension of RTS 27 best execution reports
5. Alleviating the cost benefit analysis requirements for clients
6. Exempting product governance clauses for corporate bonds

What this means for Research and Unbundling

If the changes go through, whether or not more research coverage will translate to greater investment in SMEs is debatable, but there is one outcome that is certain—the need for more technology to manage the process, both from a sell and a buy-side perspective. The operational complexity in being able to re-bundle research payments for small- and mid-cap companies, when market cap is a dynamic process is fraught with complications which EMS and order routings currently are not yet set up for.

The latest EU proposal appears to be largely political—but there is rationale behind the proposal. More does need to be done to support the equitization of small and mid-cap companies, it is just questionable that reverting to the status quo will deliver, when it hasn't historically. Perhaps instead more radical ideas are required. How about a EU wide public exchange for all primary issuance, fully fungible so that when secondary shares are traded, these can be traded according to liquidity on secondary market venues; or tax incentives such as UK Enterprise Investment Scheme (EIS); Seed Enterprise Investment Scheme

7: http://bit.ly/2U6Ev45
8: https://www.ft.com/content/f697a093-4e1b-4ef4-9b16-820198e4a67f

(SEIS) or Social Investment Tax Relief (SITR)[9] for asset managers to invest in small and mid-caps.

Alternative solutions suggested by the EU Commission include encouraging exchanges and SME growth markets to set up programmes to finance research on SMEs or exploring how to fund SME research with public money, including creating an EU-wide SME research database. The Commission acknowledge this would be difficult to implement in practice, however establishing a low-cost database would ensure the widest possible access by market participants—retail and professional—improving SMEs visibility to the maximum number of investors. One of the challenges with this proposal is who will provide the research and how the providers could be remunerated to cover the cost of production.

Interestingly the EU Commission also recognise the growing use of Artificial Intelligence (AI) and machine learning (ML) to improve the production of research on SMEs. Algorithms could be used to automate the collection of publicly available data and deliver it in a format that meets the analysts' needs at a lower price point. Use of ML could also more effectively target who is interested in which research. This would make research less costly to produce as well as more relevant to the consumers.

The ability to store, clean, and consume data that provides an edge to pinpoint alpha must be economically viable. The shift in incorporating third-party data and technology partners will be vital in democratising this process. Not all firms yet have access to meaningful data at a reasonable cost nor the ability to dedicate significant resources to make the best use of it. Although large global asset managers currently seem ahead of the curve, the increased use of third-party providers will provide a valuable step-up for those unable to invest in personnel and internal resources to the same extent.

It is not a question of whether or not to roll back elements of MiFID II, but how the asset management industry invests in the wider economy. This is not just a question of increasing analyst coverage, but a broader debate on how information on companies can be accessed and distributed across the industry 24/7, that is how European Capital Markets will develop and thrive in the digital age.

9: https://www.gov.uk/guidance/venture-capital-schemes-tax-relief-for-investors

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Rebecca is considered to be one of Europe's leading industry voices on market structure, regulatory reform, and financial services technology. She has authored a plethora of qualitative research reports and commentary covering the impact of market regulation on all asset classes, changing market structure and developments in dark pools, HFT, and surveillance. She joined Liquidnet in July 2016 to use her 20 years' experience to collaborate and deliver research and insights for both the European equities and fixed income markets. Rebecca is also Co-Chair of the FIX Trading Community's EMEA Regulatory Subcommittee, dedicated to addressing real business and regulatory issues impacting multi-asset trading in global markets. She has held prior roles at TABB Group, Incisus Partners, the British Embassy in Bahrain, Credit Suisse, Goldman Sachs International, and Bankers Trust International.

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Charlotte joined Liquidnet in May 2017 to work with Rebecca Healey on EMEA market structure and deliver research and insights about the European financial markets. Charlotte joined from Reed Exhibitions where she was a mergers and acquisitions analyst. Prior to Reed Exhibitions, Charlotte held a role at The Boston Company Asset Management in Boston.

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