
Position Paper on MiFID II proposals within the European Commission's Capital Markets Recovery Package

The European Commission's 24th July 2020 draft act (open for feedback until 11th September 2020) amending Delegated Directive (EU) 2017/593 as regards the regime for research on small and mid-cap issuers and on fixed-income instruments to help the recovery from the COVID-19 pandemic.

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Introduction

AFME supports the objectives of the European Commission's Capital Markets Recovery Package, as part of the Commission's overall COVID-19 recovery strategy and welcomes the opportunity to comment on the targeted adjustments to the MiFID II research unbundling regime set out in the draft delegated act¹ (the "Proposal").

We welcome the Commission's initiative to improve market conditions to allow capital markets to manage the challenges and support the recovery from the COVID-19 pandemic. It is, however, important to note that a more comprehensive review of MiFID II and MiFIR in 2021, aligned with the general advancement of the Capital Markets Union, remains essential to improve the efficiency of Europe's financial markets.

AFME position common to both SME and FI instruments

AFME welcomes the Commission's stated goals to increase the availability of information on SME and fixed income instruments to facilitate investment in the real economy and free up resources for both firms and investors. While AFME members note ESMA's Report on Risks, Trends and Vulnerabilities of 2 September 2020², which did not find material evidence of harmful effects on research coverage from the MiFID II unbundling rules, the Commission's stated intention to take steps to improve research coverage is noted and generally supported.

The Commission expects that targeted exemptions from the unbundling rule should result in an increase of research coverage for SME coverage and information on fixed income issuances. AFME members have a range of views on the proposals and alternatives available to most effectively achieve these goals. Members consider that further measures could be taken to achieve these objectives and would welcome the opportunity to discuss such further measures with the Commission in due course.

AFME notes that Article 1 Amendments to Delegated Directive (EU) 2017/593 in the Proposal introduces the concept of optionality at the investment firms' discretion in the disapplication of the research regime for both or research on small and mid-cap issuers and on fixed income instruments. This optionality is beneficial, but it does come with the addition of increased complexity onto an already complex regime. In particular, care is required in order to ensure that the US no action relief issued in connection with MiFID II unbundling rules (which is predicated on unbundling being mandatory for EU portfolio managers and investment advisers) continues to apply. Our comments and suggestions take this into account.

1) AFME comments on the European Commission's proposals to increase SME research

AFME recognises the importance of the objective to improve access to capital markets funding for SMEs.

However, it is our assessment that many aspects of the European Commission's proposals to increase SME

¹ <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>

² ESMA-50-165-1287

research in the draft are not optimal in order to achieve the stated policy objectives.

We set out below the particular concerns facing AFME members as a result of the present Proposal. In addition to the below, AFME notes that the balancing measures in proposed paragraph 11, and particularly 11(a), are potentially unclear and onerous for investment managers and advisers in a rule that is intended to alleviate the administrative burden of the Article 13 regime. We therefore encourage the Commission to review these requirements with representatives of the investment management community.

a) Geographic scope

As discussed above, the optionality of the provision as drafted may create issues with the SEC no action relief provided in connection with the unbundling regime. If the definition of issuer was narrowed to only cover issuers whose primary equity listing is in the European Union, the potential conflict with the US no action relief could be materially alleviated as research analysts covering issuers primarily traded upon EU exchanges are generally based outside the United States.

b) The regime should be optional for both buy-side and sell-side

Whilst the Proposal provides an optional regime for portfolio managers and investment advisers, as drafted it appears that an investment firm providing execution services is required to amend its arrangements to allow any client to take advantage of the proposed regime. Such amendments would likely include renegotiation of agreements as well as potentially complex system changes, the time and financial cost of which may far outweigh the benefit (if any) experienced by the sell-side firm in providing such amendments to clients. Further, as a general principle, it seems disproportionate to impose these alternative arrangements on the sell-side when they are optional for buy-side. We would welcome the opportunity to discuss alternative approaches to remedy this issue.

c) Practical aspects of identifying SME issuers

The Proposal introduces a rolling, backward looking assessment of market capitalisation for determining which issuers are deemed SMEs for the purposes of the proposed provisions, requiring assessment over “*12 months preceding the provision of the research*”. This would be operationally complex to monitor and could lead to an unwillingness to use the new regime for fear of falling foul of the requirements in the absence of incontrovertible, reliable, timely metrics.

AFME members would support refining the definition of SME issuer to set the lookback assessment at a precise date based upon the closing price on average during the 12 months ending on 15 November. We recommend this assessment date because firms typically negotiate their research arrangements on a calendar year basis, and this date would therefore allow an assessment of the universe of relevant SME shares prior to such negotiations. We recommend that ESMA be mandated to produce an annual list so that the industry is on a level footing as to which issuers are within the scope of the new regime.

The Proposal as drafted refers to research which is “exclusively provided on” SME issuers. In practice, SME research rarely discusses only SME issuers, but typically will refer also to large companies in the relevant sector as a point of comparison. As such, AFME recommends an amendment to the reference to such research, so that the exemption applies to research that “focuses on” SME issuers. This will ensure that firms are able to take advantage of the exemption where they wish to do so.

AFME proposed action

For the reasons described above AFME recommends not to adopt the proposed amendments as drafted with respect to the SME research regime. AFME would appreciate the opportunity to discuss alternative approaches to assist in addressing some of the issues with the existing proposal identified above.

2) AFME comments on the European Commission's proposals to increase fixed income research

AFME welcomes the Commission's statement in the explanatory memorandum to the Proposal that research costs on fixed income instruments are not embedded in spreads. AFME agrees that unbundling was not relevant for fixed income markets as (i) these are principal-based trading markets with no identifiable charge for research, and (ii) best execution obligations mean that the provision of research is unable to influence portfolio managers' decisions as to execution venue in these markets. As such, these markets were not exposed to the investor protection issues around inducement and transparency issues which drove the imposition of the unbundling rules.

Although AFME members welcome the Commission's acknowledgement of the operation of the FICC markets, and agree with the Commission's statement that introducing the unbundling rules added to compliance costs and also led to additional fees required to obtain research, AFME considers that the approach set out in the Proposal is unlikely to achieve the Commission's aims. In reviewing the Proposal, AFME members have a range of views as to the best approach to help achieve the Commission's stated goals to increase resources for business continuity and increase the availability of information on fixed income securities. Some members consider that the present MiFID II regime, having now been implemented, is operational, and has brought a measure of clarity and consistency to the market. These members have concerns that attempts to reverse the existing rules will result in significantly increased cost and complexity for both clients and providers without achieving the Commission's desired outcomes. These members also note that, unlike the SME research quick fix proposals produced by the Commission, where there have been various prior consultation efforts with constituents in the market place, there has been no similar process followed for the fixed income proposals. Therefore, some members would prefer that no changes be made to the existing MiFID II rules applicable to FICC research without the Commission undertaking an appropriate market consultation with affected stakeholders (including the consumers and producers of fixed income research).

That said, other members support a change in the rules. They feel that ongoing implementation of the current MiFID II regime for fixed income will continue this increased bureaucracy and cost for buy-side and sell-side firms. There are different views as to the changes that may more effectively meet the Commission's objectives. AFME would welcome the opportunity to discuss with the Commission two potential approaches together with details of the purpose, potential advantages and potential issues of each. Each potential approach has its own complexities, and potential risks of additional operational costs and differences in interpretation; each could result in significant additional costs arising from client outreach, negotiation and restructuring on both the buy side and the sell side.

In each such approach the counter-balancing provisions in paragraph 11 of the Proposal would not be relevant to FICC. AFME notes that an ex ante agreement with respect to the portion of any payment attributable to research cannot be established with respect to principal-based trading markets because, as acknowledged in the Commission's explanatory memorandum, the trading amount paid does not include a charge for research.

AFME proposed action

AFME would appreciate the opportunity to discuss the issues raised in this paper and these alternative approaches with the Commission.

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About AFME

AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.