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UK Investment Research Review: Reforming MiFID II and Revitalising Investment Research in the UK Public Markets

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Introduction

In July 2023, the Investment Research Review (the Review) commissioned by the UK government published its findings into investment research in UK capital markets. The Review made the following seven recommendations, seeking to protect and develop the UK as a “centre of excellence” for investment research:

- Allow additional optionality for paid investment research, including by allowing UK buy-side firms to pay for research from outside the UK on a bundled basis if that is the practice in the relevant jurisdiction.
- Increase access to investment research for retail investors.
- Involve academic institutions in supporting investment research initiatives.
- Introduce a research platform to help promote, service and disseminate investment research.
- Support issuer-sponsored research by implementing an industry-wide code of conduct.
- Clarify certain aspects of the UK regulatory regime related to investment research and consider introducing a bespoke regime.
- Review the rules relating to investment research in the context of IPOs.

The UK government has since affirmed its intention to implement all of these recommendations. We discuss the key areas of reform in more detail below.

Generally, the Review notes that the quantity, and in some instances the quality, of investment research has decreased for some years. Improvements to the investment research regime would stop the decline in distribution of and access to investment research in the UK. Encouraging research production and expanding the types of investors that have access to analyst research would increase the attractiveness of UK capital markets and improve liquidity, particularly for companies with smaller market capitalisations.

Overhauling the rules related to investment research has long been discussed as an area of post-Brexit regulatory reform in order to decrease friction in the public markets. This topic has become particularly pertinent amid a regulatory and investment industry-wide effort to kickstart UK equity capital markets and expand the role of public markets in the British economy. The production and distribution of analyst research on UK-listed companies is seen as a crucial piece of this puzzle.

Capital Markets Alert

UK Investment Research Review: Reforming MiFID II and Revitalising Investment Research in the UK Public Markets

Toward Bundling

Under the UK Markets in Financial Instruments Directive (MiFID II), payment for investment research in the UK must be “unbundled” and charged for separately rather than included as part of a package that may include, for example, execution and related services. The Review recommends adopting a more flexible approach toward bundling.

The EU has already addressed some of the frictions arising from MiFID II’s bundling rules. As of 2021, firms became able to bundle costs for research and execution in respect of small and mid-cap issuers whose market capitalisation did not exceed €1 billion. Further, the EU Listing Act proposals released in December 2022 include amendments to MiFID II that would require client disclosure and the labelling (and organisation) of issuer-sponsored research.

Recognising the restrictions of separate payment for investment research (and following the EU’s lead), the UK has already implemented some limited reform. In 2022, the Financial Conduct Authority (FCA) relaxed the bundling rules in relation to investment research by expanding the list of “acceptable non-monetary benefits”. This definition now includes:

- i. Investment research relating to issuers with a market capitalisation of below £200 million (considerably lower than the EU’s amendment in 2021).
- ii. Research on fixed income, currencies and commodities (FICC) instruments.
- iii. Research from independent research providers.

This reform was welcomed by the industry, particularly in relation to fixed-income research providers that are much fewer in number and usually part of broker-dealer offerings by large investment banks.

Moreover, the MiFID II restriction on bundling payments for investment research is fundamentally different from the rules in the United States, pursuant to which providing clients with research “incidentally” as part of a wider set of brokerage services (and therefore bundling payments for research with fees for such brokerage services) actually allows broker-dealers to avoid registration with the US Securities and Exchange Commission under the Investment Advisers Act of 1940 for distributing research.

Responses to the Review’s previous Call for Evidence suggest that the benefit of these post-MiFID II revisions remains to be seen, citing the complex systems that had already been implemented for MiFID II compliance and the operational challenges involved in distinguishing smaller-cap companies.

To address these concerns, as well as those arising from divergence from the US regime, the Review recommends removing the restriction on bundled payments. Instead, the Review recommends that buy-side firms should be able to pay for investment research on a bundled basis with execution charges, in addition to paying from their own resources or making a specific charge directly to their clients for the cost of research. The Review recommends that the UK regulations include a clear, specific exception that allows payment for investment research, rather than relying on an unclear safe harbour for “acceptable minor non-monetary benefits”.

The Review also recommends that buy-side firms should:

- Allocate the costs of research fairly between their clients.
- Make use of allocation arrangements, such as commission-sharing agreements.
- Establish and implement formal policies on their approaches to investment research.
- Periodically undertake benchmarking or price discovery.
- Make appropriate disclosures to clients.

Sell-side firms should not be required to facilitate payments on a bundled basis.

The FCA committed to begin immediate engagement to inform market participants of any rule changes regarding the removal of the requirement to unbundle research costs by the end of the first half of 2024.

Clarity on the UK’s Regulatory Perimeter

The Review notes that regulating the provision and distribution of investment research is “unnecessarily complex” in terms of determining whether UK authorisation is triggered, and proposes that the FCA should review its current rules with an intent to simplify them.

Providing investment research does not itself amount to a regulated activity, but “advising on investments” is regulated.¹ A large proportion of investment research includes features to suggest its characterisation as regulated advice, meaning that it is difficult for unauthorised persons to provide investment research.

The UK’s financial promotions regime also applies to investment research, but whether “independent” research — rather than “non-independent research”, which is regarded as purely marketing material if it is not presented as objective information or otherwise described as independent — amounts to a financial

¹ Article 53(1) the Financial Services and Markets Act (Regulated Activities) Order 2001.

Capital Markets Alert

UK Investment Research Review: Reforming MiFID II and Revitalising Investment Research in the UK Public Markets

promotion is unclear. The regulatory perimeter can, therefore, seem difficult to determine; much more so than in the EU regime. Although the distinction between independent and non-independent research is derived from MiFID II, there are no financial promotion rules at the EU level (although Member States may have similar national regimes). The FCA may decide that its clarification of the regulatory boundaries should involve the creation of a bespoke regime tailored specifically to investment research.

Creation of a New Research Platform

A central facility for the promotion, sourcing and dissemination of research in the UK, if implemented, would echo similar platforms that other financial services centres, such as Germany and Singapore, have established. The Review recommends establishing a research platform to support investment research on all UK publicly traded companies willing to participate. In particular, improved coverage of small cap companies would promote interest and liquidity in the UK markets. Free access could widen participation of retail investors and facilitate the participation of academic institutions in investment research, which is another recommendation in the Review. The Review anticipates that the establishment of a UK research platform could foster a virtuous circle by supporting broader coverage and long-term investment.

Participation in the research platform would not be compulsory for any issuer, and could even be used to initiate research on private companies that are contemplating a listing. A set of standardised contracts forming the platform's constitutional framework — in the way that exchanges have their own frameworks — would maintain participant confidence in and the security of the platform.

Greater Access to Investment Research for Retail Investors

Facilitation of retail investors' access to investment research is considered key for improving trading liquidity, particularly for those securities of companies with smaller market capitalisations. Although retail investors can access public disclosures for publicly traded securities, they are less able to access investment research than professional investors are. Lack of access to investment research risks retail investors' overreliance on informal sources such as chat rooms and social media.

Given the potential value of retail investors' participation in UK markets, the Review recommends that the FCA address this asymmetry by issuing guidance or amending FCA rules. The new UK Consumer Duty that came into effect on 31 July 2023 will require authorised firms to "deliver good outcomes for retail customers" organically in their provision of investment research (if this investment research does indeed fall within the regulatory perimeter). The Consumer Duty introduces a new regulatory principle,

reflecting higher standards for firms to adhere to when providing products and services to customers in retail financial markets.²

Interaction With IPO Timetable

Investment research is an important feature of UK IPOs, particularly with regard to the transaction timetable. Analysts may be "connected" if they are employed by financial institutions with a mandate on the IPO, or "unconnected" if they are not connected with such financial institutions. Increasing the access of unconnected analysts in order to produce research was a key aim of the FCA's revised Conduct of Business Rules in 2018, which resulted in an amendment to the IPO timetable to encourage and accommodate (i) access by unconnected analysts to the company conducting the IPO and (ii) the publication of unconnected research. Currently, before a prospectus is published, a company seeking a listing must provide unconnected analysts with access to the issuer's management on equal terms and at the same time as connected analysts get access in order for research by connected analysts to be published one day after an FCA-approved registration statement or prospectus. If unconnected analysts are not granted access at the same time as connected analysts, investment research by connected analysts cannot be published until at least seven days after publication of an FCA-approved registration document or prospectus. However, given the tendency of issuers to withhold access from unconnected analysts until later in the process due to a desire to control the narrative around a transaction, unconnected research has not clearly benefitted from these rules, which nonetheless have extended timetables for UK IPOs. Moreover, the restrictions placed on connected analysts puts the UK equity markets at a disadvantage. The Review recommends, among other things, that regulators review and simplify the IPO timetable, while continuing to encourage the adequate and timely access of unconnected analysts in IPOs.

Conclusion

The Review proposes major reforms to the existing MiFID II regime and, if its recommendations are adopted, they would be expected to increase the quantity and accessibility of investment research to both institutional and retail investors. The proposed reforms are significant but not surprising given long-standing industry complaints regarding the adverse consequences for investment research that resulted from MiFID II, and the reforms align with changes that have already been proposed in the UK and the EU.

The timing of the Review is significant because reforming the regulatory regime governing the production and dissemination of investment research is a critical part of efforts by the UK government and investment industry to revitalise UK equity

² For more detail on the consumer duty, see our February 2023 client alert "UK Adopts a New Consumer Duty: Key Implications for Financial Services Firms."

Capital Markets Alert

UK Investment Research Review: Reforming MiFID II and Revitalising Investment Research in the UK Public Markets

capital markets by increasing the attractiveness of listing in London and the amount of capital invested in the UK public markets. While the existing proposals to reform the UK Listing Rules and change the UK prospectus requirements are aimed at reducing the regulatory burden for issuers (both existing and prospective) by moving toward a disclosure-based regime, relax-

ing the rules around investment research and its dissemination is aimed at encouraging increased activity and liquidity in the equity markets. While the Review and its consequential regulatory changes will not be a panacea for the UK equity markets, the proposals, if implemented, will contribute to their expansion even if the positive effects may not be immediately apparent.

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