REVIVING RESEARCH IN THE WAKE OF MIFID II

Observations, issues and recommendations

January 2020

Jacqueline Eli-Namer and Thierry Giami would like to thank the AMF staff, especially Anne Désire and Victor Maurin, for their assistance in conducting this work.

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LETTER OF ENGAGEMENT

AUTORITÉ DES MARCHÉS FINANCIERS
AMF

:

The Chairman

Paris, 9 July 2019

Mrs Jacqueline Eli-Namer
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The coverage of listed companies by independent research is an essential component in ensuring that prices are properly established on the market and to guarantee liquidity. While the major listed securities are amply covered, the smaller caps, which are by definition held on average by a smaller number of investors, are traditionally less closely followed by analysts.

The implementation of MiFID II, which requires research to be billed separately, seems to have both accentuated this trend and modified the market economy of research. The fall in prices of invoiced research, coupled with the streamlining of investors' budgets, has apparently led to a reduction in the number of analysts and the companies covered; at the same time, research sponsored by issuers is on the rise. Although this has curbed the decline in research production, it raises specific issues, particularly with regard to conflicts of interest management.

Although the objective of the Paris marketplace is to promote the listing of small- and mid-caps, and while France has a broad base of financial analysts, it is advisable to explore, without waiting for hypothetical regulatory developments, the initiatives that could be taken to ensure that small- and mid-cap companies are covered by high-quality research .

The AMF Board would be grateful if you would fine-tune your assessment of the direction in which research is headed and explore concrete ways of mobilising the marketplace so as to improve the current situation. Conclusions submitted by early November would allow implementation before the end of the year.

The AMF is at your disposal to assist you in your work and in your communications with market participants.

Robert OPHELE

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INTRODUCTION

Research plays an essential role in the orderly functioning of financial markets. It is produced by investment firms, investment banks or independent firms for investors and contributes to the valuation of companies and financial instruments, and to portfolio performance. Research coverage contributes to the improved liquidity of listed assets and the way their prices adjust. The changes introduced by the MiFID II reform have transformed the research business model.

This reform was adopted to resolve potential conflicts of interest in the payment of research by order execution fees, and has led to the establishment of a market for financial analysis. Research is now a business service remunerated for its value on its own, and is no longer bundled with other services (unbundling).

Two years after the Directive came into force, most participants in the Paris marketplace consider that the reform has undermined financial research production capacity, which has deteriorated over the past few years, especially for small and mid caps for which the scope of coverage stands at a low.

Given this situation, the Chairman and Board of the Autorité des Marchés Financiers (the "**AMF**") entrusted Mrs Jacqueline Eli-Namer, Board member, and Mr Thierry Giami, President of the French Society of Financial Analysts (SFAF), with the task of producing a diagnosis of the direction in which research is moving and exploring tangible ways of mobilising the marketplace and improving the current situation (the "Task Force").

The Task Force endeavoured to gather the observations of representatives of the financial industry and transferable security investment professionals, to highlight the impacts of the MiFID II reform on the long-term trends of the Paris financial market and to make recommendations in order to stimulate demand for research provided by diversified suppliers.

The strategy adopted aims to actuate three levers: the sale of research, research paid for by an issuer and the supply of research.

This has major implications for the investment of domestic and savings from abroad in financing the economy, and especially for innovative companies based in France to obtain the resources needed for their growth.

It is for these reasons and on the basis of this work that the Task Force sets out a plan to stimulate research. The AMF has a decisive role to play within the field of its remit.

IMPACTS OF THE MIFID II REFORM ON THE ECONOMICS OF RESEARCH

1. A REFORM INTRODUCED IN A RELATIVELY UNFAVOURABLE MARKET ENVIRONMENT

The changes to research introduced by MiFID II have come in a difficult macroeconomic environment with primary markets – where capital is raised – in decline since 2017. Moreover, fund management has seen a decline in investor appetite and an increase in competition, while passive management continues to thrive and private equity becomes increasingly attractive.

AN UNFAVOURABLE ECONOMIC AND FINANCIAL ENVIRONMENT

The MiFID II reform is taking place in an unstable environment in which "deflationary" trends, especially in Europe, have ultimately predominated. Zero or indeed negative short- and long-term interest rates have prevailed throughout 2018 and 2019. Similarly, demand for capital in the markets has retreated. Passive management has continued to grow. These combined circumstances have weakened demand for research.

A CONTRACTION IN DEMAND FOR CAPITAL

In equity primary markets, initial public offerings in 2017 and 2018 remained at low levels in terms of the number of companies involved and the amount of capital raised. The contraction was amplified in 2019 for all firms, while markets recorded historical highs, but in declining volumes.

Number and amounts (in millions of euros) of initial public offerings in Paris

	2017		2018		2019 (January-October)	
	Number	Amounts raised	Number	Amounts raised	Number	Amounts raised
Compartment A	1	1,707.8	1	697.1	1	-
Compartment B	2	484.8	2	60.1	0	-
Compartment C	4	186.4	4	150.5	1	35.0
Euronext Growth	8	55.8	10	185.3	3	79.3
Grand total	**15**	**2,434.7**	**17**	**1,092.9**	**5***	**114.3***

Source: Euronext-Paris

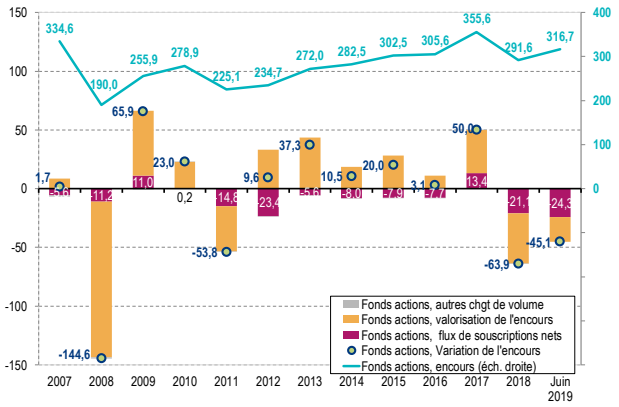
*Note *: compared with 15 IPOs recorded between January and October 2018, for an amount of €1.07 billion.*

Over the first ten months of 2019, the number and amount of IPOs declined by half compared with the same period of the previous year, particularly in the SME segment, where the amounts raised by IPOs also tended to be extremely small.

INVESTOR DIVESTMENT

Fund outflows from French equity funds reached €24 billion year-on-year in June 2019. This outflow is the largest since 2007.

Change in assets under management, net inflows and revaluation of French equity funds
(in EUR billion, year-on-year)



The growth in assets under management (AUM) in 2019 is due solely to the rise in the markets and does not offset outflows. AUM remain lower than their levels of 2017. In a period of high volatility, prudential rules tend to incentivise market participants to reallocate their portfolio towards assets entailing low market risks.

FLAGGING FUND MANAGEMENT REVENUES

Fund management, which is a major industry in France, sustained the combined shocks of competition and falling interest rates as well as rising costs involved in adapting to the regulations. This caused revenues to fall off due to fee reductions.[1] This fall in revenues had repercussions on bought-in or in-house services, notably research.

GROWTH IN PASSIVE MANAGEMENT

The growth of passive management seen in recent years has had a negative impact on the market for research. By way of illustration, although passive management is not confined to Exchange Traded Funds (ETFs), in less than four years net European ETF assets have practically doubled, from €400 billion at end-2015 to €750 billion by mid-2019, in line with a global trend.

By comparison, entire UCITS AUM funds over the same period increased by only 25% to €10,150 billion in June 2019.

AN ATTRACTIVE PRIVATE FINANCIAL MARKET

At the same time, private equity and corporate debt posted record volumes and valuations, thanks to low interest rate debt financing. In the case of many assets, this market is tending to replace the public financial market given the facilities and financial benefits it provides for investors and issuers.

[1] The operating profit of the French asset management market fell significantly (-10.6%) in 2018 according to AMF data

These trends, mentioned by all Paris marketplace participants interviewed by the Task Force, were under way before the MiFID II reform took place. They represented a preliminary to their analyses of the impacts of this reform, on which this report is based.

2. THE FRENCH RESEARCH MARKET

ORGANISATION OF THE FRENCH FINANCIAL MARKET…

The French market ecosystem has a wealth of diversified stocks, with more than 650 companies listed on Euronext Paris. In recent years, however, this number of companies has tended to decrease.

The production of research on these stocks is performed by a large number of players of varied size who produce high-quality research used by global market participants. Nevertheless, this research is mostly focused on large caps. In this sector, independent analysis companies represent less than 10% of the players.[2] In general, it should be noted that the population of analysts has undergone continuous erosion since MiFID I.

Lastly, investment management companies are the main consumers of research from a diverse range of suppliers. According to AMF data, there were 633 investment management companies in France at the end of 2018.[3]

… WITH A LONGSTANDING SHORTAGE OF COVERAGE OF SMALL AND MID CAPS…

The fragility of corporate coverage is a recurrent issue for European markets, and especially the French market. This is the case for small and mid caps for which the market capitalisation and free float are relatively small.

This problem is all the more acute for small and mid caps, which have historically been less well covered. A study by the AMAFI,[4] published in September 2018 of analysts' coverage of French stocks from December 2005 to December 2017, showed that the coverage of stocks increased with their market capitalisation.

At 31 December 2017, stocks with a capitalisation of less than the €10 million threshold were hardly covered, whereas those with more than €5 billion were covered by 20 analysts on average at the same date. These figures are the result of a continuous decline in coverage since 2012, except for the segment of stocks with a capitalisation of between €10 million and €150 million. Several efforts by the marketplace have already attempted to revitalise this segment of small and mid cap research, but have not succeeded in reversing the downward trend.

…WHICH REPRESENTS A PROBLEM FOR FINANCING THE ECONOMY

Yet research, the appeal of small and midcaps for investors and their liquidity are all closely linked. The risk is the formation of a negative spiral: less followed companies have a lower degree of visibility among investors, who turn away from them, thus further weakening them in their ability to obtain financing. Such a situation seems especially prejudicial at a time when

[2] SFAF, Independent financial analysts commission

[3] "Key Figures for Asset Management in 2018 – Overview of Investment Management Companies", including more than 450 entrepreneurial investment management companies according to the AFG French asset management association. The AMF data show that the 20 leading players, in terms of assets under discretionary management, together account for a 91.9% market share

[4] AMAFI, "Financial analysis, Study on the coverage of French stocks by research firms from 2005 to 2017", 28 September 2018

the French and European authorities share the strong ambition of strengthening means for financing the economy.

The great majority of research producers agree that this business does not in itself generate profits. If in a booming stock market, brokers have been able to maintain a research business thanks to the revenues generated by stock market operations, the slowdown in IPOs and low stock liquidity have highlighted the structural weakness of this activity and its questionable viability.

MIFID II ESTABLISHED A MARKET FOR RESEARCH WHICH HAS YET TO FIND ITS BALANCE

The main change brought about by MiFID II in the research sector was to create a market, with supply, demand and prices, by comparison with the previous system where the value of research was indistinguishable from the transaction fees. Hence small, mid and large cap research could be pooled. Given this observation, the Task Force endeavoured to assess the consequences of the reform in terms of efficiency and development of financial market research.

3. IMPACTS OF THE MIFID II REFORM ON THE RESEARCH ECOSYSTEM

ON THE WHOLE PARTICIPANTS HOLD A NEGATIVE VIEW OF THE REFORM

It should be noted that the reform was introduced without political debate nor a preliminary impact analysis, notably regarding the data, contrary to the normal procedures for enactment of European legislation. This lack of an analysis meant it was not possible to take the specific features of each country into account, notably with regard to corporate brokerage[5] in the United Kingdom. During the interviews conducted by the Task Force, the participants almost unanimously mentioned negative effects of MiFID II on financial research in both quantitative and qualitative terms, especially for small and mid caps.

The Task Force therefore gathered data from various market participants and trade associations. However, this data does not allow a clear-cut assessment.

In 2018, the changes seem relatively insignificant. Most of the Paris marketplace participants surveyed by the Task Force emphasised the fact that the impact of MiFID II would only be fully visible in the figures for 2019 and expect that 2019 will be extremely poor for research.

Moreover, Europe is the only major region to have adopted unbundling of research and brokerage with MiFID II, whereas the United States, the largest global research market, maintains payment of research via brokerage fees (the soft dollar remains the rule in the United States).[6]

CONTRACTION IN THE COVERAGE OF TRANSFERABLE SECURITIES

Those interviewed consider positively the fact that MiFID II has made it possible to give a price to financial research, whereas until then this service appeared "free of charge". A market for financial research has appeared, taking the place of research often perceived as abundant.

[5] See Appendix 3

[6] In this situation, the US Securities and Exchange Commission (SEC) nevertheless announced on 4 November 2019 the extension of the *no action letter* on payment for research until July 2023. Securities Industry and Financial Markets Association, *SEC Staff Extension of No-Action Letter* (Nov. 4, 2019) : this letter allows US broker-dealers to receive payments from clients subject to MiFID II in hard dollars or via a research payment account ("RPA") without having to adopt the status of investment advisor. Apart from the technical difficulties obliging the global players to very often develop two systems, these differences can also create a certain legal uncertainty for the players in cross-border relations

However, most players emphasise that by aiming to rationalise supply, the reform has led to a fall in corporate coverage.

For example, the CLIFF[7] studies, carried out in mid-2019, show a decline in the stock coverage universe:

- On Compartment A, the decline in coverage is 15% on average;
- On Compartment B, it is 26% on average;
- On Compartment C, the coverage remains relatively stable.

Moreover, for the French marketplace, MiFIDVision shows a slight deterioration in the rate of coverage of companies whose market capitalisation lies in a range between €150m and €500m ("*microenterprises*"),[8] while observing an increase in the relative number of large medium-sized enterprises (companies whose capitalisation ranges between €500m and €1 billion) followed by at least two analysts (67% of companies in March 2019, versus 65% at the end of 2017).

An analysis of investment service providers (ISPs) carried out by the AMF[9] suggests that there is a correlation between greater coverage of small caps, especially those that have a capitalisation of less than €200 million, and an increase in the number of issuer contracts.

Generally speaking, it should be noted that the effect on coverage is the last visible effect, since brokers try to maintain this aspect in priority. In practice, therefore, they tend to increase the size of each analyst's portfolio rather than reduce coverage. Again in the context of the MiFIDVision initiative, the SFAF highlights a 12% reduction in the number of analyses between 2018 and 2019 (the number decreased from 1,960 to 1,730), despite an increase in the number of issuers followed (+3 %).

RESEARCH PROVIDERS WEAKENED POSITION

As regards revenues, many producers emphasise that the effects of the reform on revenues in 2018 were not conclusive. This can be explained, according to the AMF's analysis, by a combination of the following factors:

- "reduced" revenues in 2017, which do not take research services paid for in execution fees into account, which could account for the sharp increase in the 2018 revenues of certain small intermediaries;
- in 2018, a "windfall effect" in the accounts due to the introduction of the new types of research funding. Some research firms booked a residual payment combined with the invoicing of MiFID II research contracts.

Since none of the above phenomena prevailed in 2019, many firms expect a more marked drop in revenues in 2020 due both to the economic and financial environment and the reduction in fee tariffs. Moreover, the gradual application of the reform by clients is mentioned by several firms.

Accordingly, while it is still too early to establish a precise assessment for 2019, reported drops in revenue thus far often range between 20% and 30% on average, and up to 50% in some cases. Several firms reported a decline of almost 20% in the number of active clients on the European continent between 2018 and 2019. Several brokers stress that 2019 has been an extremely tricky year.

[7] CLIFF studies, 2018-2019, based on a sample of 52 companies in May 2018 and 40 companies in May 2019

[8] For this category, while the proportion of the companies followed least (stocks not covered or covered by a single analyst) has declined slightly, the weight of the stocks followed most closely (companies followed by at least five analysts) has likewise declined.

[9] Conducted based on gathering replies to a questionnaire sent by the AMF to fifteen ISPs in July 2019.

These firms are especially vulnerable in that their other sources of revenue, in particular execution revenues, were sharply impacted either by small transaction volumes or by particularly fierce competition, leading some of them to offer execution free of charge.

Finally, the AMF's analysis of ISPs shows that the industry is consolidating and that the number of analysts is declining, with numbers dropping by 12% between the end of 2017 and 30 June 2019.[10]

RESEARCH FUNDED BY THE ISSUER TO COMPENSATE FOR THE DECLINE IN RESEARCH COVERAGE

To offset this decline in research, intermediaries and issuers now increasingly use "sponsored" analysis, i.e. research paid for by the issuer. Thus, according to the data gathered by the AMF, on 31 December 2017, 289 research contracts were financed by the issuer. There were 343 such contracts on 31 December 2018, and 368 on 30 June 2019.[11]

The Task Force notes that research paid for by the issuer is at present recognised by all participants met (intermediaries, fund managers, investors), who see it as the market adapting to the MiFID II framework. Most intermediaries have produced such research for several years, often linked to liquidity contracts, considering that the conflicts of interest which could arise from this type of activity are manageable provided the research is well supervised. Others, historically opposed to this type of research due to independence issues, report that they are now considering including it in their business offer. Fund managers and investors have also already integrated it in their processes, stressing that this represented a major source of data.

PARTICIPANTS' QUESTIONS REGARDING THE DECLINE IN QUALITY

The participants raise questions concerning the deterioration in the quality of financial research, even though this issue remains hard to quantify. This phenomenon, already present with MiFID I, and which apparently affects both small and large caps, is alleged to have been strengthened by MiFID II.

The perception of a decline in quality was forthcoming in various surveys
The CLIFF[12] association provides figures which would appear to confirm this trend, or but that does provide an overall observation picture. 53% of respondents to the aforementioned surveys mention this. The observation allows more conclusions to be drawn for market capitalisations of less than €500 million, a category for which the percentage of respondents having this opinion rose to 67%.
Moreover, according to a study[13] by the CFA Institute France, although most *buy-side* market participants perceive no deterioration in the quality of research, *sell-side* market participants generally more negative. For example, 44% of *sell-side* analysts consider that the level of quality of research has declined, especially for small and mid caps.

[10] However, the data reveal a phenomenon that was underway before the implementation of MiFID II. For example, the total number of professional licences issued by the AMF for all the French firms was 590 on 31 December 2005, 410 on 31 December 2013 and 395 in May 2019. However, it should be noted that this indicator does not correspond precisely to the number of analysts, because ISPs can assign licences to outgoing branches when the regulations of the host country do not have a similar system, and incoming branches are not obliged to assign professional licences to their financial analysts. However, the historical depth available makes it possible to recognise a long-term structural trend.
[11] The figures of the CLIFF are along the same lines. While, in 2018, 60% of issuers replying to the CLIFF and whose market capitalisation was less than €1 billion used financial analysis paid for by the issuer, 89% did so in 2019. According to studies by the CLIFF, for two-thirds of these issuers capitalising less than €500 million, financial analysis paid for by the issuer is the only research available to them. Moreover, according to the SFAF, the number of research contracts financed by the issuer increased in France from 100 to 295 in one year.
[12] Cf. note 9 p.7 for the sample
[13] CFA Institute, *MiFID II: One year on – Accessing the Market, Assessing the Market for Investment Research*, 2019. Survey carried out with the members from 6 to 19 December 2018, with 496 replies.

The Task Force notes the perception of a deterioration in the quality of research by a majority of respondents, based on three criteria:

- Financial analyses are shorter, less substantial and more neutral;
- A larger number of stocks followed by each analyst. This assessment is confirmed by the AMF's analysis of ISPs which shows an 11% increase in the number of stocks covered by each analyst between December 2017 and June 2019;
- Average length of analysts' experience has declined, a phenomenon referred to as "juniorisation".

THE RIGIDITY OF RESEARCH MARKETING CONDITIONS

Under MiFID II, the regulators have controlled trial periods by limiting them to three months, as specified by ESMA Q&A and by the AMF in its guide.[14] This approach, which was designed to manage potential conflicts of interest, was called into question by several participants. According to them, this three-month period not only clashes with the research cycle, which is half-yearly, but also, as a consequence, freezes market share. More specifically, some raise questions concerning the relevance of this time limit for independent firms, whose visibility with investors was ensured precisely by sending research.

MiFID II also limited access to research consumers, considering the entity solicited rather than the product line covered by a commercial approach. For example, a supplier keen to have research on equities tested by an entity will no longer be able to send financial research on bonds once a trial period has begun, and until one year after the end of said trial period has lapsed. Some emphasise that this view of business relationship with clients greatly reduces marketing opportunities without the benefit being clearly apparent.

LACK OF CLARITY IN THE PRACTICE OF CORPORATE ACCESS

By defining the concept of minor non-monetary benefits, the European legislator has made business relationships between various participants unclear and more complex, especially with regard to "concierge services", thereby weighing the necessary dialogue that must take place between an investor and an issuer.[15]

PORTFOLIO ASSET MANAGEMENT COMPANIES HAVE MOSTLY CHOSEN TO TAKE CHARGE OF PAYMENT FOR RESEARCH…

The fund management industry is faced with strong competition, notably from passive management. As a consequence, portfolio asset management companies have had to grant reductions in management fees. They therefore pass this downward pressure on to all their cost centres, and notably the research cost centre, especially if they have chosen to pay for research out of their revenues, which is the case for the broad majority of fund managers.

Insofar as over half of these companies have chosen to recognise research costs in their profit and loss account, rather than pass them on to the end client, financial research has become a cost centre. This choice can be explained partly by the regulatory complexity surrounding the establishment of a research payment account (often designated by the acronym RPA), and partly by pressure from end investors, who considered that they paid the price of research in management fees. Moreover, portfolio asset management companies have faced a regulatory constraint which has meant that the great majority of them no longer receive fund management retrocession fees.

[14] See Appendix 1 on the regulatory framework

[15] See Appendix 1 on the regulatory framework

… NOTABLY BY RATIONALISING THEIR CONSUMPTION OF RESEARCH

In any case, it transpires that portfolio asset management companies now watch their research budgets closely, as revealed by the interviews and the replies to the AMF questionnaire distributed by the AFG, the French asset managers association.[16] This development has changed the nature of the relationship between asset managers and brokers.

For example, the majority of companies have carried out a stricter selection of research providers. In this environment, these companies' Finance Departments now play a more important role research purchasing budget decision making. Accordingly, some of those interviewed regret that fund managers are no longer sufficiently represented in brokers' selection committees, especially for management companies that specialise in small and mid-caps.

Several examples of rationalisation

By way of illustration, some investment management companies state that between 2017 and 2018 they reduced the number of equity research providers that they used by two-thirds. In every case, these companies state that they have retained the services of global players, which offer a diverse range of services for a low price, and niche players, which enable them to meet precise needs not covered by their in-house research (e.g. intermediaries which provide access to emerging markets). These companies stress that they regularly reassess the research providers used, whether they be small or large.

This rationalisation, together with price competition between sell-side research companies, has led to a reduction in budgets set aside for spending on external research.

Taking as a basis the estimated budget for 2017, in 2018 the budgets decreased by 25% to 50% and then, in some cases, by a further 30% to 50% in 2019 according to the AFG's figures.

In parallel, a trend towards insourcing of research is gaining momentum, especially with certain major players. This phenomenon is contributing to a further reduction in demand for research. This is generally a strategic decision, with in-house and external research supplementing one another in the management process.

This trend towards rationalisation of financial research by portfolio asset management companies, in some cases combined with its insourcing, may also lead investment management companies, especially the large ones, to make less and less use of brokers' corporate access services, by obtaining access to issuers directly.

[16] Questionnaire distributed in October 2019 to AFG members, and which received more than 70 replies.

4. THE PRICE OF RESEARCH REMAINS A KEY MATTER

MIFID II IS UNCLEAR ON PRICE…

Since MiFID II, firms, both producers and consumers, must assign a price to research, whereas previously payment for research was linked to trade execution volumes. MiFID II thereby contributed to the emergence of a research market which in itself allows firms greater transparency. However, the Regulation did not really define its fundamental rules, especially with regard to price competition, based on the principle that the market would adjust by itself. This shortcoming had the consequence of destabilising the competitive position of European firms.

Commercial negotiation phase is now described as highly competitive, especially in 2019. The great majority of research providers are therefore adjusting the price of these services downward.

…LEADING TO FIERCE COMPETITION AT THE EXPENSE OF CERTAIN FIRMS

Multiservice offers from major global financial players who apply extremely competitive fee schedules for research17 currently serve as a benchmark for a large part of the market, which has had no alternative but to align with these practices. Moreover, some firms question the degree of adequation between a research service and the price of such a service. They stress that since the price of research continues to fall, this is increasingly seen as a benefit granted to research consumers.

To absorb this price shock, several alliances, domestic and international, have been struck or are planned by research firms. At the same time, several firms have pursued pan-European alliance strategies enabling them to pool their resources and expand their product offering.

In general, and especially in the French market, the reform has undermined the research ecosystem, both for the research producers, whose capacity has diminished, and for consumers, for whom research is now an explicit cost item.
The firms have adapted, via major rationalisation plans, still in progress, in a broadly deflationary context. The listed SME segment is especially affected by these changes, notably due to the disappearance of the cross-subsidies that existed with intermediaries between large and small caps.

[17] The loss-leader prices for access to very vast research offerings are around €10,000. However, they often come together with value-added services.

TASK FORCE RECOMMENDATIONS

The existence of research on listed securities plays a fundamental role for a security's valuation and liquidity. Ensuring the production of research, by providing markets with a reliable level of information, contributes to market efficiency and hence the security of invested savings.

Corporate financing by financial markets is above all a question of capital investment in transferable securities. This investment is currently limited by restrictive regulations for professional investors and a tax system that is insufficiently incentivising for retail investors. Positive changes in this field could boost research market growth.

The MiFID II framework organises the research market and this market has yet to settle. Its implementation has already raised several questions concerning the functioning of this market, characterised in particular by deflationary trends which are weakening a number of providers. Furthermore, the new regulations have acted as an amplifier of structural issues affecting the SME segment. Financial research on these stocks is declining, and has in some cases become insufficient, even though the financing of small and mid caps is a key factor contributing to the vitality of the marketplace ecosystem. This, moreover, is the primary objective of the Capital Markets Union, as reasserted by the Demarigny Report,[18] and the French authorities have shown the need to act to bolster companies' financing capacity, via the PACTE Law[19] and the Tibi Report.[20]

The persistence of varied, independent local research producers is essential to the French financial ecosystem. In the light of this situation, the Task Force proposes three sets of proposals to strengthen and expand research production capacity.

The first series of recommendations aims to strengthen the supply of research. The second proposes supporting the expansion of sponsored research. Lastly, the third series provides "oxygen" for the research market via several adjustments to the existing framework.

The Task force also invites the AMF to examine rapidly the report's recommendations that fall within its field of regulation and to come up with proposals that could lead to changes in the national and/or European framework.

1. STRENGTHEN CAPACITY TO PRODUCE AND DISTRIBUTE RESEARCH

Given the usefulness of research for markets' functioning, strengthening the capacity to produce and distribute research would therefore appear to be a key condition for effective financing of the economy, notably in the small and mid caps segment.

ENSURE SATISFACTORY FUNCTIONING OF THE RESEARCH MARKET FROM A PRICE PERSPECTIVE

MiFID II has led to the development of a supply of research services at extremely low prices, which would seem to be detrimental to a healthy competitive environment. Several firms consider that the prices at which research is sold are highly competitive, with no common comparison to those offered previously, and even resemble dumping practices.

The MiFID II Regulation does not stipulate what is a fair price, and the AMF is not a competition regulator. Besides, it is unlikely to be able to easily demonstrate the existence of forms of cross

[18] *Savings and Sustainable Investment Union*, The Next CMU High-Level Group, October 2019
[19] French Act No. 2019-486 of 22 May 2019 on business growth and transformation
[20] Philippe Tibi Report, *Financer la IVe révolution industrielle - Lever le verrou du financement des entreprises technologiques* (Funding the fourth industrial revolution - Removing the financing obstacle for technology firms), July 2019

subsidies enabling unfair competition by diversified international financial groups with European firms subject to MiFID II.

However, the Task Force considers that a substantial research offering, implying the allocation of significant resources and offered at very low prices, could resemble a form of inducement.[21]

First, this subject could be mentioned and clarified by the AMF in its guide to research funding within the framework of MiFID II (the "Guide").[22]

Moreover, the Task Force feels that the European framework could be modified to introduce a form of adequation between the price of research and its cost of production in more explicit terms (see Part 3.1 hereafter).

In parallel, the AMF could inform the competent authorities of the various practices posing problems in this market, be it the Competition Authority or the European Commission's Directorate General for Competition.

LAUNCH A "RESEARCH MARKETPLACE" TO INCREASE SUPPLY

The structural weakness of the market, exacerbated by the changes brought about by MiFID II

The production of research on small and mid caps is the (regularly flagged) structural weakness of the Paris financial market. The initiatives taken by the financial industry and the authorities to correct this have not reversed this situation which is prejudicial to companies and investors.

The changes introduced by MiFID II have caused a further deterioration in the rate of coverage of these companies by financial analysts. This is because the pooling of revenues generated by execution and research is no longer authorised.

The "sponsored" research solution

To correct this situation, investment service providers have conceived a form of research "sponsored" by the issuer, which is yet commonplace in the London financial marketplace. Issuers find an interest in this because, by providing investors with information on companies, this solution allows those companies to continue presenting their earnings reports to the financial market.

Nevertheless, although this may provide a quality and ethically acceptable solution, it cannot be seen as a substitute for independent research produced by the financial industry for investors.

A new independent research economy

Hence it is more a question of building a new independent research economy. The legislator wanted research to become a market in its own right. It is quite obvious that the Paris marketplace has inherent strategic interest to organise this new economy, since the quality, quantity and frequency of qualified, independent financial information are prime instruments of competitiveness, in order to value companies, attract capital, optimise liquidity, and in a word, finance the economy itself.

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[21] The concept of resource allocation is mentioned in Recital 30 of the Delegated Directive of 7 April 2016, which specifies that: "*In particular, any non-monetary benefit that involves a third party allocating valuable resources to the investment firm shall not be considered as minor and shall be judged to impair compliance with the investment firm's duty to act in their client's best interest.*"

[22] *Guide on the new rules governing the funding of research by investment service providers under MiFID II*, published on 17 January 2018

The "research marketplace"

Such a market would take the form of a virtual "research marketplace". Therein, investment service providers and research firms would exchange financial research with investors. Investors would volunteer to share the funding of research and for which they pay a market price. They would cover small, medium-sized and innovative stocks on their initial public offering (IPO). Thus, this independent research would be added to the research paid for by the issuer on its IPO.

Financial community for the common economic good

A "research marketplace" would of course be temporary, until the market is built and has found its equilibrium in the MiFID II environment. This would quite obviously be governed by the Paris marketplace. Reviving research, with special focus on small, midcaps and innovative companies, is a Paris financial community project, with the shared business interest of corporate and financial market financing.[23]

The Task Force proposes that the AMF provide, within its remit, engagement with the Paris marketplace to create a "research marketplace" to support and develop independent research.

PROVIDE FINANCIAL SUPPORT FOR THE PRODUCTION OF RESEARCH ON INNOVATIVE COMPANIES

Apart from the fact that it concerns small companies entailing high risks, research on innovative companies covers technologies and markets which require major investments quite simply to make them known.

Moreover, innovative companies enjoy major benefits in terms of government funding, in a bid to foster their growth. This is the case, in particular, via Bpifrance funding programmes open to such companies.

The Task Force therefore proposes establishing a correlation between public financial support for innovation and research on an innovative company carrying out a public offering or already listed, by allowing this type of research to benefit from Bpifrance funding programmes.

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[23] The model could be organised as follows:

(i) Eligible issuers: any company whose market capitalisation is at most one hundred and fifty million euros which carries out a public offering or which has made such an offering one or two years before the year of launching the "research marketplace", and which has been covered by research for the above reason;

(ii) Eligible analysts: the analysts of the Paris marketplace, in their respective organisations;

(iii) Allocation of analysis: it is allocated by the "research marketplace" to volunteer analysts based on criteria of expertise, ethics and distribution;

(iv) Distribution of the research: the analyst and their organisation, the issuer, professionals, networks and platforms, and the "research marketplace";

(v) Price of research: the market price;

(vi) Financiers: French and European public investors such as the CDC, Bpifrance, EIB, and the French and European private sectors;

(vii) Business model: companies floated on the stock exchange, analyses funded for initial and follow-up research, operating expenses of the "research marketplace". The approximate budget for three years is €3 million. For example, based on the assumption of 20 companies floated on the stock exchange per year from year n to n+2, €20,000 for initial analysis and €10,000 for n+1 and n+2 follow-up analysis, with an annual budget of n = €400,000, n+1 = €600,000, n+2 = €800,000€, the total price would be €1,800,000, to which should be added a small operating budget insofar as the activities are outsourced;

(viii) The legal model: an appropriate legal structure whose assets would consist of research while its liabilities would consist of the financiers' stakes.

The VAT treatment applicable to research production, notably for independent research firms, could introduce a bias in the choice of analyst by the consumer.

The Task Force proposes an alignment of the VAT treatment for research market players on the treatment for research consumers, in particular fund managers.

PLAN FOR THE DEVELOPMENT OF NEW FORMS OF RESEARCH, INCLUDING ESG

New forms of research, for example, based on the processing of big data or on artificial intelligence, are growing significantly. The taking of extra-financial considerations into account, especially environmental, social and governance criteria (ESG), is gathering momentum. These developments provide opportunities for the expansion of the research market and marketplace firms.

Taking these changes into account is a strategic competitiveness issue for the Paris marketplace, which could become a leading centre for the production of this type of research.

The Task Force proposes encouraging these new research sectors by acting in particular on certification of the analysts called on to produce ESG research.

The Task Force also proposes providing innovative research firms with an ecosystem that could contribute capital and demand, just as the Émergence marketplace fund does for fund management.

CONSIDER ESTABLISHING A FAIR CONTRIBUTION FOR MARKET PARTICIPANTS

Financial markets have seen the remarkably rapid growth of passive management. This management segment benefits from a price formation mechanism to which it does not contribute. There is, as it were, a "free rider" in the research market. This situation establishes a bias at a time when research is becoming a fee-based intellectual service.

The Task Force recommends the launch of a reflection on this matter at a European level, so that those who are consumers of research, directly or indirectly, contribute to payment for research.

2. SUPPORT THE DEVELOPMENT OF SPONSORED RESEARCH

The development research funded by issuers, generally called "sponsored" research, has been observed since implementation of MiFID II. Discussions between the Task Force and market participants have shown that its growth has accelerated in 2019. This phenomenon reflects a move by brokers to adapt to the post-MiFID II business model of research production. In several European countries, moreover, rules nudge issuers to acquire a long-term research commitment. In Italy, for example, Bolsa Italiana's markets (including AIM Italy) oblige an issuer to pay for research. Likewise, AIM London requires that listed companies retain a broker who, in most cases, provides research.

In France, issuers see an interest in funding their research themselves to maintain a high level of visibility with investors.

This type of production has become a reality in our ecosystem. Its usefulness is acknowledged by most of the investors and asset management companies interviewed.

However, acknowledgement of this research suffers from a disparity of practices and misgivings on its independence. It is therefore recommended to ensure exemplary execution of this research and to be thoroughly transparent regarding on its funding by the issuer.

Recognition of the value of sponsored research requires the definition of good practice. A regulatory framework for sponsored research would include the term used to designate such research, the charter, the contract, self-regulation and distribution.

Designate research paid for by the issuer

If the parties agree on the need to state the sponsor in order to prevent conflicts of interest, the expression used for this research is a subject of broad debate between advocates of the expression "marketing material" and those advocating "research paid for by the company … ".

The Task Force proposes opting for the expression "research paid for by the company …", providing for clear and systematic information on the research note. In this way, the research would be standardised to make the link between the analyst and the issuer immediately clear to the reader.

Charter for issuer-paid research

Establishment of a charter on the research paid for by the issuer (the "Charter") would appear to be an essential tool for the qualification of production. Such a Charter would provide a guarantee regarding the intellectual independence of the analyst, its expertise and the conditions of research production.

Furthermore, this Charter would specify the ethical requirements of the analyst's profession, it would ensure that non-sponsored research and research paid for by the issuer are produced to the same standards of quality, and it would also deal with the matter of the distribution of this research. The initial work carried out by the industry associations follows these lines.

The Task Force recommends the immediate launch of a marketplace consultation with the AMF's participation to establish this Charter.

Model contract for issuer-paid research

In addition to the Charter, a model contract between issuers and analysts would be produced. Its objective is to identify and define the roles and relationship of signatories.

To ensure even greater independence of research, the Task Force recommends that the provisions of these contracts stipulate sufficiently long time scales for the relationship to avoid conflicts of interest, and in line with the cycle of initial research and its follow-up.

Moreover, such a contract would be clearly distinct from liquidity provision contracts[24] or other services provided by the research producer.

Self-regulation

The Task Force recommends that the French Society of Financial Analysts (SFAF)* perform supervision of the system and provide support for analysts and their organisation for any ethical issues they could face.

Distribution of research paid for by the issuer

It is in the interest of the marketplace to ensure broad distribution of this issuer-paid research.

[24] The practice of liquidity contracts is permitted by Regulation (EU) No. 596/2014 of 16 April 2014 on market abuse ("MAR Regulation")

* **Note that Thierry Giami is currently chairman of the SFAF**

This depends on the contractual terms agreed between the producer and the issuer. It would be in the interest of the marketplace for broad distribution of issuer-paid research to be organised.

Regarding this, the Task Force recommends that such distribution be made possible by the major suppliers-aggregators of financial information and financial information platforms.

The Task Force considers that reflection could be held at a European level concerning research paid for by issuers given the diversity of situations.

3. IN LIGHT OF EXPERIENCE, ASPECTS OF THE REGULATORY FRAMEWORK TO BE ADJUSTED

Since the implementation of MiFID II, practice has shown that a number of requirements which were designed to improve investor protection have impeded research production. The Task Force therefore proposes a series of adjustments, the combined effects of which could facilitate the activity of intermediaries and improve the research market as a whole. Also, the problems of price adjustment on this market should lead to the inclusion of a principle making it possible to adapt prices.

INTRODUCE A CONCEPT OF A "REASONABLE COMMERCIAL BASIS"

Price has already been introduced in the MiFID II Directive in the form of the reasonable commercial basis concept (RCB) in connection with the cost of market data.[25]

To ensure improved market functioning, it is recommended to introduce into the MiFID II system a concept of a price representative of the service.

SIMPLIFY CORPORATE ACCESS

Several of those interviewed mentioned a lack of separation between so-called concierge services and corporate access. Out of caution, many professionals choose to include concierge services within the scope of corporate access.

The Task Force feels it is reasonable to consider concierge services as a minor non-monetary benefit because they do not influence the investor's decision making. It is incumbent on the investor to ensure compliance with the rules governing conflicts of interest.[26]

EASE THE REQUIREMENTS ON THE TRIAL PERIOD

The strict requirements governing trial periods should be eased to facilitate business relations. The European regulators currently authorise trial periods, considered as a minor non-monetary benefit, when these meet certain conditions.[27]

It would be beneficial for the ecosystem if this trial period were eased, along two lines.

On the one hand, the Task Force recommends that **the conditions required for qualification as a minor non-monetary benefit should be applicable to only <u>one</u> class of financial instruments over a given trial period. Accordingly, a research consumer could use several trial periods with a given firm, but on <u>different</u> classes of financial instruments <u>(e.g. equities/bonds/derivatives)</u>**.

[25] Article 13 of MiFIR and Article 64 of MiFID II. While this concept is used in MiFID II to limit the cost of data, it would be useful here to ensure a match between price and service rendered

[26] This approach could be conducted via ESMA Questions and Answers or more reliably by a delegated act

[27] See Appendix 1

Also, the Task Force proposes **allowing extension of a trial period and a reduction in the length of time between two trial periods**. This period, specified by the AMF in its Guide and by ESMA,[28] is currently three months and cannot be extended by the parties during the twelve months after it ends. By permitting an extension of the trial period with a given provider, it will be easier for a company to assess the quality of the research on a new investment universe during a period which could be up to six months, taking into account the typical research cycle.

Lastly, the Task Force recommends reducing to six months the length of time between two trial periods to allow the presentation of research services to be in step with new developments in the financial market and the occurrence of events which have an impact on securities.

ENSURE A DIVERSITY OF PARTICIPANTS: CONSIDER THE POSSIBILITY OF EXEMPTIONS OR A FORM OF PROPORTIONALITY

In-depth reflection should be launched to introduce greater **proportionality** into the rules governing research funding. Requests for proportionality in this respect are not new, and this could take several forms.

Consider proportionality on small caps

Proportionality could, for example, be applied according to the type of stocks covered: research on small and medium-sized companies would not come under the measures of Article 13 and would therefore be exempted – in full or in part – from the obligations of establishing a budget ex ante, and follow-up and revision of said budget. More specifically, it is proposed that, if an amount is announced to the client, this amount may be exceeded at any time provided that it is possible to justify this ex post.

Consider proportionality on small research consumers

Although in practice there is no direct link between the size of a portfolio asset management company and the asset category in which it invests, proportionality could also be applied to small **research consumer firms** (asset management companies), under various conditions. The size criterion could be measured based on the amount of assets under management or, as provided for in French law prior to MiFID II, on the basis of research spending. These firms could be allowed to not be subject to the MiFID II measures, which would allow the return of a form of mutualisation.

Another solution is to design a less burdensome system for research consumers subject to MiFID II, who could be exempted from part of the requirements, by proposing to them a form of "simplified payment account", knowing that the present requirements related to this payment method widely adopted by small participants are often criticised for the administrative and procedural complexity they involve. Below a threshold that remains to be defined, the research consumer firm would, for example, have to estimate an overall budget at corporate level, irrespective of the investment strategy/universe, or of the services. Alternatively, it could be considered to exempt this type of firm from the obligation of establishing a budget ex ante, which makes it impossible to manage the budget within the year even in the case of additional research needs. This firm could even be relieved of the obligation of ex ante agreement of its clients, while maintaining the distribution of information to the client via another channel.

[28] See Question and Answer 12, section 7 of the document *Questions and Answers on MiFID II and MiFIR investor protection and intermediaries topics*

Limit the impact of MiFID II on independent research

Independent financial analysts, defined as analysts providing **no other service than the research offering**, have suffered severely since the implementation of the reform, even though their offering is by nature free of conflicts of interest.[29]

It is therefore necessary to state clearly that their offering is not subject to the MiFID II regulations on financial research, and that consumers can buy their production outside of the MiFID II rules. These derogatory conditions would enable research consumers subject to MiFID II to receive the research produced by these independent firms freely without fear of legal risk, because no constraint of client transparency or justification of utility for making decisions on investment management and buying at the right price would be applicable.

The Task Force recommends that the production of research by independent financial firms as defined above should be covered by conditions derogating from the provisions of MiFID II and that this derogation should take effect as soon as possible in light of the critical situation in which these analysts find themselves.

ASSESS THE RELEVANCE OF THE CONCEPT OF INDUCEMENT REGARDING RESEARCH

More general thinking could be done about the advisability of removing financial research work from the inducements system. This qualification and all the consequences that it entails were the subject of neither a policy debate nor a cost-benefit analysis when the system was introduced via the establishment of the "level 2" MiFID II implementing measures, in 2014-2016. There should at the very least be an assessment of whether a bespoke system could be established by which only research provided free of charge (or at a clearly undervalued price) would be subject to regulation. The increased severity of the rules governing conflicts of interest and best execution requirements could be sufficient to manage risks of conflicts of interest.

The Task Force proposes that the AMF requests that ESMA carry out an initial qualitative and quantitative European review of MiFID II implementing measures as early as 2020.

4. PROVIDE INCENTIVES TO INVEST RETIREMENT SAVINGS AND EMPLOYEE SAVINGS IN LISTED SMES

The research market would obviously benefit from the development of market financing and an increase in the number of listed companies.

Corporate financing by the financial market requires providing incentives for investment in small and mid caps, given the small market capitalisation of these stocks, their narrow free float and shallow liquidity. On top of this come restrictive regulations for "equity" investment of collective savings schemes such as life insurance. The government therefore recently took measures concerning retirement savings plans and the flat-rate employer contribution ("*forfait social*") applicable to companies, in order to increase the capital invested in small and medium-size enterprises.

Modelled on the Tibi Report's proposal to introduce French Tech Investment-labelled funds , the Task Force proposes that employee savings schemes and retirement savings be encouraged to invest in funds invested in listed SMEs or a mix of large and small or mid caps, by duplicating the framework of "solidarity"-labelled funds and "Socially Responsible Investment" (SRI).

[29] As a reminder, Recital 27 of the Delegated Directive reiterates the purpose of these measures, indicating that, in accordance with Article 13, research consumer firms should ensure that "*the cost of research funded by client charges is not linked to the volume or value* ***of other services or benefits or used to cover any other purposes, such as charges for execution***"

CONCLUSION

Maintaining research production capacity is essential to the quality of the marketplace ecosystem and, ultimately, to the capacity for obtaining market financing locally.

The measures governing research funding introduced by MiFID II have severely undermined a number of participants. The segment of small and mid caps, which suffered previously from very scarce coverage, is in an even worse situation.

Strengthening the production of equity research seems a realistic objective. The forthcoming discussions on a review of MiFID II point to opportunities for adaptation. This review is in line with a French and European context favourable to corporate financing by the financial market.

The mobilisation of market participants, notably those who stepped forward during the work of the Task Force, is essential to ensure the development of research via the emergence of adapted solutions.

The Task Force considers that effective implementation of the recommendations and the production of tangible results are key factors for the success of the Paris marketplace. The Task Force invites the market's industry associations to initiate a plan to stimulate research, organise its deployment and measure its effects.

SUMMARY OF THE TASK FORCE RECOMMENDATIONS

I. Strengthen the capacity to produce and distribute research

- Ensure satisfactory functioning of the research market from the price perspective

This subject could be mentioned and clarified by the AMF in its guide to research funding within the framework of MiFID II (the "Guide").

Moreover, the Task Force feels that the European framework could be modified to introduce a form of adequation between the price of research and its cost of production in more explicit terms

- Launch a "research marketplace" to increase supply

The Task Force proposes that the AMF provide, within its remit, engagement with the Paris marketplace to create a "research marketplace" to support and develop independent research.

- Provide public financial support for the production of research

The Task Force proposes establishing a correlation between public financial support for innovation and research on an innovative company doing a public offering or already listed, by allowing this type of research to benefit from Bpifrance funding programmes.

The Task Force proposes an alignment of the VAT treatment for research market players on the treatment for research consumers, in particular fund managers.

- Plan for the development of new forms of research, including ESG

The Task Force proposes encouraging these new research sectors by acting in particular on certification of the analysts who produce ESG research.

The Task Force also proposes providing innovative research firms with an ecosystem that could contribute capital and demand, just as the Émergence marketplace fund does for fund management.

- Consider establishing a fair contribution for market participants

The Task Force recommends the launch of a reflection on this matter at a European level, so that those who are consumers of research, directly or indirectly, contribute to payment for research.

II. Support the development of sponsored research

Recognition of the value of sponsored research requires good practices to be defined. A regulatory framework for sponsored research would include the terms to designate this research, the charter, the contract, self-regulation and distribution.

The Task Force proposes opting for the expression "research paid for by the company …", providing for clear and systematic information on the research note.

The Task Force recommends the immediate launch of a marketplace consultation with the AMF's participation to establish this Charter.

The Task Force considers that reflection could be launched at a European level concerning research paid for by issuer given the diversity of situations.

III. In light of experience, aspects of the regulatory framework to be adjusted

- Introduce a concept of a "reasonable commercial basis"

To ensure improved market functioning, it is recommended to introduce into the MiFID II system a concept of a price representative of the service.

- Simplify corporate access

The Task Force feels it is reasonable to consider concierge services as a minor non-monetary benefit because they do not influence the investor's decision making. It is incumbent on the investor to ensure compliance with the rules governing conflicts of interest.

- Relax the requirements surrounding the trial period

The Task Force recommends that the conditions required for qualification as a minor non-monetary benefit should be applicable for only one class of financial instruments over a given trial period. Accordingly, a research consumer could use several trial periods in a given firm, but on different classes of financial instruments (e.g. equities/bonds/derivatives).

The Task Force proposes allowing extension of the trial period and a reduction in the length of time between two trial periods.

The Task Force recommends reducing to six months the length of time between two trial periods to allow the presentation of research services to be in step with new developments in the financial market and the occurrence of events which have an impact on securities.

- Ensure a diversity of participants: consider the possibility of exemptions and/or a form of proportionality

Deep reflection should be launched to introduce greater proportionality into the rules governing research funding.

The Task Force recommends that the production of research by independent financial firms as defined above should be covered by conditions derogating from the provisions of MiFID II and that this derogation should take effect as soon as possible in light of the critical situation in which these analysts find themselves.

- Assess the relevance of the inducement concept for research

The Task Force proposes that the AMF asks ESMA to carry out an initial qualitative and quantitative European review of MiFID II implementing measures as early as 2020.

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APPENDICES

1. TASK FORCE WORK METHOD

The Task Force endeavoured to establish a quantitative and qualitative assessment of MiFID II by gathering the analyses of a broad range of stakeholders.

Between September and October 2019, the Task Force accordingly carried out a series of interviews with 41 financial sector participants, representing 38 institutions of varying sizes and in various businesses (people involved in active and passive management, hedge funds, broking, investment banking, independent financial research companies, but also providers of platform solutions), and delegations from professional associations, experts and public authorities – AMF, Financial Conduct Authority (FCA), the Treasury Department, and the European Securities and Markets Authority (ESMA). Most of those met were based in Paris, but the Task Force also had discussions with several market participants based in London.

All hailed this study as a good idea, almost two years after implementation of MiFID II.

Over the same period, the Task Force also gathered the opinions of the AMF consultative commissions on the market, investment management and issuers, and received a number of contributions from Paris marketplace participants – in particular issuers – via a call for comments published on the AMF website.

The Task Force also analysed the results of a questionnaire to which more than 70 asset management companies replied, and an AMF survey carried out with about fifteen brokers.

Lastly, the Task Force took advantage of the results of the work carried out by Paris marketplace initiative MiFIDVision, led by the French Society of Financial Analysts (SFAF) and bringing together the main components of the ecosystem (French asset management association AFG, French association of institutional investors (Af2i), AMAFI (French association of financial markets), Cliff, French employers' association Medef (Mouvement des Entreprises de France), and Euronext, among others), and the analyses conducted by the AMF since the implementation of MiFID II.

2. REGULATORY CONTEXT AND GENERAL OBJECTIVE OF THE REFORM

Before the Markets in Financial Instruments Directive ("MiFID II")[30] and in the area of financial research, the European legislation dealt basically with conflicts of interest which could affect the producer entities, without having a significant influence on the funding model.

On the international level, the regulatory treatment of financial research was still determined by the report and statement of principles issued by the IOSCO in September 2003. Focused on management of conflicts of interest for sell-side analysts and the entities employing them, these two documents had laid down major principles such as the need to ensure that analysts' integrity was not compromised by their financial interests and their personal transactions, nor by the transactions and commercial relations of their employer, or else the need for the employers of sell-side analysts to establish procedures, management lines and pay conditions which eliminate or significantly limit potential conflicts of interest. The issuers of financial instruments should not unduly influence analysts.

[30] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments, amending Directive 2002/92/EC and Directive 2011/61/EU

EUROPEAN SITUATION PRIOR TO MIFID II

On the European level, the deployment of these principles governed the treatment of financial research by the Market Abuse Directive ("MAD") and the Markets in Financial Instruments Directive ("MiFID I"). The MiFID I implementing directive provided in particular for measures relating to the regulation of analysts' personal transactions and "Chinese walls" to ensure the independence and objectiveness of financial research.

In a "Communication" of December 2006[31] which reviewed the provisions of the European legislation on financial research and financial analysts, the European Commission classified the receipt of research coupled with the execution of transactions among the "benefits" as defined in MiFID I. It also reiterated that such benefits were acceptable only on the twofold condition (i) that the clients of the buy-side entity be informed of this, and (ii) that these benefits "are designed to improve the quality of the provision of the investment or ancillary service concerned to the client, and do not impair compliance with the firm's duty to act in the best interests of the client ". The Communication also mentioned Commission Sharing Arrangements as a method facilitating compliance with these requirements.

In a report issued in April 2010, ESMA's predecessor, the Committee of European Securities Regulators, reiterated the obligations placed on investment firms ("IFs") which accept benefits and, in the specific case of research, mentioned certain replies to the consultation which considered that the use of CSAs ensured compliance with these obligations. However, the MiFID I classification of the receipt of financial research among non-monetary benefits did not significantly change the underlying business model: for equity research, the research continued to be paid for by the funds or portfolios managed, at a price depending on the volume of transactions executed; for other underlying assets, the free provision of research was not called into question.

THE TREND TO REGULATION OF RESEARCH FUNDING

The trend towards unbundling was launched in the early 2000s. In 2001, Paul Myners submitted to the British Treasury a report calling for increased transparency of commissions paid to brokers (and potentially affecting the investment decisions of institutional investors), and selection of service providers. The report recommended that commissions be paid for directly by asset management companies, and no longer by investment funds. This report largely inspired further initiatives taken in the United Kingdom in favour of stricter control of brokerage fees and an unbundling of execution and research services. In November 2013, the FCA issued a consultation on the use of brokerage fees, followed, in May 2014, by a position paper banning the use of brokerage fees to remunerate corporate access and research services considered "non-substantial". It is against this backdrop that, when drawing up the European MiFID II implementing regulations ("level 2" regulations), the idea occurred that research should be treated as an inducement.

THE MIFID II FRAMEWORK

Since 3 January 2018, research funding has been governed by the MiFID II Directive and the Delegated Directive of 7 April 2016[32] (the "Delegated Directive") for the purpose of protecting investors and limiting the risks of conflicts of interest, which restricts - or even prohibits - investment service providers ("ISPs")[33] from receiving or paying inducements or benefits.

[31] https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:52006DC0789

[32] Commission Delegated Directive of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits.

[33] The cited legislation refers directly to investment firms, but these provisions also apply to credit institutions as per Article 1.3. b) of MiFID II when they provide one or more investment services and/or perform investment activities, and to asset management companies for the provision of investment services as per Articles 6.6 of the AIF Directive (Alternative Investment Funds) and 6.4 of the UCITS Directive (Undertakings for Collective Investment in Transferable Securities) IV

MiFID II considers that the provision of research constitutes for the entity that receives it a form of inducement, i.e. a benefit, in the broadest sense, entailing potential conflicts of interest. Now, since 3 January 2018 the receipt of any inducement has been prohibited within the framework of the provision of third-party portfolio management services (or discretionary management) or investment advisory services provided on an independent basis.

For other services, the receipt of any inducement depends on an objective of improvement in the quality of service. Moreover, Article 13 of the Delegated Directive describes in detail how the rules relating to inducements should apply to the specific case of third parties providing ISPs with research work.

More specifically, Article 13[34] requires that research should be funded by one of the following two methods:

- Direct payment of research work out of the ISP's own resources; or
- Payment by the ISP's clients out of a separate research account controlled by the ISP, on certain operational conditions of functioning and transparency. The research funding system provided for by MiFID II requires, in particular, that the research consumer firm define a budget beforehand when it decides to have research paid for by its clients. This system should lead to a formalisation of the practices of the research consumer firm and of the relations it maintains with its clients.

MiFID II excludes from the regime in Article 13 of the Delegated Directive all minor non-monetary benefits, which may therefore be retained by investment firms with no additional requirements, as they present a low conflict-of-interest risk. A definition of minor non-monetary benefits is specified in the specific provisions applying to investment advisory services and portfolio management services. They must fulfil two conditions: these benefits are likely to improve the quality of service provided to a client; their magnitude and nature are such that they cannot be considered as preventing the investment firm from complying with its duty of acting in the client's best interests.

Furthermore, Article 12.3 of the Delegated Directive establishes a list of the non-monetary benefits that can be considered as minor.

THE CASE OF THE TRIAL PERIOD

The AMF and ESMA specified that research work offered free of charge as part of a non-renewable trial period that is strictly supervised and limited in time, may be considered as minor non-monetary benefits for a research consumer firm, providing a portfolio management service or independent investment advisory services.

The sole purpose of this trial period must be to allow the research consumer firm to assess and evaluate the relevance and quality of the research offering, and in this sense it should be considered as protecting the interests of the end clients. In particular, it may not exceed a period of three months and may not be renewed by the parties within the twelve months following its termination. The research provider may not receive any consideration, monetary or non-monetary, which might be understood as an implicit payment.

CORPORATE ACCESS

With regard to corporate access, the regulations make a distinction between two practices:

- The practice confined to merely establishing contact by the service provider (mere material organisation of a meeting) which is considered as "caretaker services". In this

[34] Article 13 of the Delegated Directive is incorporated in French substantive law as part of the AMF General Regulation ("AMF GR"). These new rules apply since 3 January 2018, the date of application of the provisions transposing the Delegated Directive into national law.

case, corporate access does not correspond to the definition of research: it cannot be covered by the research budget. Depending on the analysis of the research consumer firm, it may correspond to a minor non-monetary benefit and therefore be accepted without financial consideration.

- The practice consisting of supporting this mere establishment of contact with intellectual value-added services such as, for example, the preparation, by the intermediary who took part in the meeting, of a detailed research note drawing the lessons from this meeting, recommending a strategy on the securities of the issuer in question or in its sector of activity and allowing the ISP to form an opinion for itself. The intellectual type services entailed by corporate access such as, for example, a summary of information exchanged during the meeting, may be invoiced separately from the charges for caretaker services. These charges may therefore be included in the research budget, unless the research consumer firm decides to pay for these costs itself.

If the service corresponds neither to research not to a minor non-monetary benefit, it may not be received within the framework of investment advisory services or third-party portfolio management, unless it is considered as a "commercial service" which the research consumer firm will fund out of its own resources for third-party portfolio management (or discretionary management) or investment advisory services provided on an independent basis.

3. THE STRONG LOCAL CORPORATE BROKERAGE CULTURE IN THE UNITED KINGDOM, WHICH PRESERVES COVERAGE ON SMALL AND MID CAPS

We should mention a fundamental difference between the French and UK markets, which explains why the latter is more resilient than the former to the effects of MiFID II on small and mid caps. This difference is the longstanding existence of a British corporate brokerage system, which appears to be specific to the UK.

Under the corporate brokerage system, a company listed on the London Stock Exchange hires a corporate broker to provide it with advice and explanations on movements affecting the markets and its own securities, and to facilitate relations between the issuer which hires it and potential investors. Corporate brokerage is a continuous long-term relationship, rooted in the British financial culture, which allows great proximity and the establishment of a relation of trust between brokers and company managers, and it is nearly always a preliminary to equity investments by the corporate broker's bank. The corporate broker supplements the work of the investor relations department by contributing its own address book.

Accordingly, in the United Kingdom, the vast majority of small issuers use the services of a corporate broker that they pay themselves (note that medium-sized issuers often have two corporate brokers).

4. ACRONYMS

Af2i: Association Française des Investisseurs Institutionnels (French Association of Institutional Investors)
AFG: Association Française de la Gestion Financière (French Asset Management Association)
AMAFI: Association française des marchés financiers (French Association of Financial Markets)
AMC: Asset Management Company
AMF: Autorité des Marchés Financiers (French financial markets regulator)
ASF: Association française des sociétés financières (French Association of Financial Institutions)
CAC 40: Cotation assistée en continu 40 (index of 40 largest French stocks)
CSA: Commission Sharing Arrangement
CFA France Institute: Chartered Financial Analyst France Institute
EIB: European Investment Bank
ESG: Environment, Social and Governance
ESMA: European Securities and Markets Authority
ETFs: Exchange Traded Funds
ETI: Entreprises de taille intermédiaire (intermediate-sized enterprises)
FCA: Financial Conduct Authority
GDP: Gross Domestic Product
IF: Investment Firm
IPO: Initial Public Offering
ISP: Investment Service Provider
MAD: Market Abuse Directive
MAR: Market Abuse Regulation
MEDEF: Mouvement des Entreprises de France (French employers' association)
MiFID I and MiFID II: Markets in Financial Instruments Directives I and II
IOSCO: International Organization of Securities Commissions
P&L: Profit & Loss
PEA-PME: "PEA-PME" personal savings plan designed to finance small and medium-sized enterprises
RCB: Reasonable Commercial Basis
RPA: Research Payment Account
SEC: Securities and Exchange Commission
SFAF: Société française des analystes financiers (French Society of Financial Analysts)
SMEs: Small and medium-sized enterprises
SRI: Socially Responsible Investment
VAT: Value added tax
UCITS/OPCVM: Undertaking for Collective Investment in Transferable Securities/*Organisme de placement collectif en valeurs mobilières*