Wholesale Conduct Policy Team
Markets Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

October 7, 2014

Dear Sir / Madam,

Re: Discussion on the use of dealing commission regime – policy debate on the market for research

Thank you for giving us the opportunity to comment on your consultation on the use of dealing commission rules.

The Investor Relations Society's mission is to promote best practice in investor relations; to support the professional development of its members; to represent their views to regulatory bodies, the investment community and government; and to act as a forum for issuers and the investment community. The Investor Relations Society (IR Society) represents members working for public companies and consultancies to assist them in the development of effective two way communication with the markets and to create a level playing field for all investors. It has over 700 members drawn both from the UK and overseas, including the majority of the FTSE 100 and much of the FTSE 250.

Following our response to the FCA consultation paper on the use of dealing commission rules earlier this year, we would like to reiterate that the IR Society welcomes recent clarifications and enhancements to the use of dealing commission rules to allow better visibility on charges. However, this is a significant structural shift in the market. We are concerned there will potentially be unintended consequences impacting corporate issuers through the unbundling of research from dealing commission, especially those in the smalland mid-cap end of the market. We outline our concerns below. With this in mind, we are surprised that there was no reference to corporate issuers in point 1.19 of your consultation paper, who we feel may bear the cost and resource constraints of regulatory change going forward, in addition to market intermediaries.

In order to examine the perceived impact of potential regulation change, specifically under MiFID II and the prevention of payments being made for research services out of dealing commission, the IR Society has recently conducted a market research study amongst 400 market participants, targeting institutional investors, sell-side analysts and corporate investor relations officers. This research highlights some of the uncertainties around the unbundling of research payments, which the IR Society believes could bring unintended consequences. The main concern uncovered by this research is that unbundling commission payments has the potential to disadvantage those smaller companies and investors who lack the necessary scale to attract costly sell-side intermediation. A summary and some analysis from our research are outlined in our answer to question two of this discussion paper.

Q1: Do you have any comments on our analysis on the potential impact of unbundling payments for research from execution arrangements, based on MiFID II proposals?

On behalf our issuer members, the IR Society believes the following potential impacts from unbundling payments for research from execution arrangements can be outlined as follows:

- **Unbundling payments for research will have most impact on mid-cap companies, and may result in disproportionate valuation anomalies:** With a restriction on the use of dealing commission to pay for research, we anticipate cost pressures and changing market dynamics in investment banking which is likely to result in sell-side coverage contracting over the next few years. This may have more impact on mid- and small-cap companies who, with a reduction in coverage may end up with limited visibility in the market. There is therefore the potential for a possible valuation gap with a decline in the quantity of research on these companies. If we see the market dynamic change with less analysts covering less stocks, their focus may tend towards covering the largest companies within a particular sector. Conversely, at the small-cap end, the market may open up for the boutique houses to covers these stocks; therefore we feel those at most risk are the lower profile mid-cap sized companies.

- **A reduction in overcapacity may yield an improvement in quality of research:** With a potential contraction in results-led and regular ‘maintenance’ research we foresee a move by analysts for more thematic research, as they move to provide more revenue generating ideas for investors. This may also provide an opportunity for independent research providers, as pricing transparency will encourage independent research houses to come into the market. With a level playing field on cost in the market for research, smaller boutique research houses may be presented with an opportunity to fulfil coverage at the small-cap end of the market. At the moment there remains uncertainty as to how this will play out in the market, although if there is a reduction in analyst coverage in the larger houses due to cost, then this could be an opportunity for analysts to move independently or to the buy-side where they may upskill their in-house research capabilities.

- **Further clarity sought on who pays for what:** Current proposals do not make clear how the economics of unbundling research are going to work. We anticipate larger investment managers may not expect to pay for research and brokers will explore other means to offer research. Costs of research may transfer to the smaller fund managers, who may also face time and resource constraints. Consequently this may adversely affect the ability to follow and invest in companies, biased sector selection and market valuation anomalies.

- **Increased unregulated research could lead to more market volatility:** With investors seeking to acquire diversified research, opportunities could open up for research businesses (outside investment banks) and independent research houses to enter the research market. It seems unlikely that these providers would all be regulated, opening the possibility of published research having a significant impact on share prices, with investors having commissioned that research and potential for unequal dissemination of information. If private research is commissioned by fund managers to gain competitive advantage, there is the risk issuers won't have the opportunity to address or respond to it, and research becomes 'opaque'. Thematic research pieces could become more controversial to gain attention from the company and in the market. Furthermore the increase of independent research and views published through social media channels won't necessarily create a level playing field and may have a disruptive influence on the market.

- **The future of analyst consensus and forecasts:** With the potential increase in more thematic research and less results-led coverage then the ability for published forecasts to become outdated is greater. However, establishing a market consensus forecast remains an important aspect in equal dissemination of information to all investors. The Society will be encouraging issuers to be proactive in ensuring analysts are keeping their models up to date and that issuers are publishing ‘verifiable’ consensus on their websites.

Q2: Do you have any analysis that would help inform our view of possible benefits or costs of extending requirements in MiFID II to cover all research goods and services?

In support of our above mentioned points, the results of our recent IR Society Policy Committee survey on the market for research has highlighted our concerns that these regulatory changes may have an impact on the mid- and smaller-cap corporate issuers in particular.

A reduction in overcapacity and improvement in quality of research is expected. A significant number of respondents are hopeful the requirement to pay for research as a disaggregated operation cost will cut back the overcapacity and drive up the quality of research being written.

A negative impact on smaller-cap issuers is likely: 78% of respondents also stated that unbundling research costs from dealing commission is either ‘quite likely’ or ‘very likely’ to have a negative impact on the depth and quality of small-cap research.

In summary, while we support improved cost transparency, we highlight these changes may cause unintended consequences and there is potential for considerable uncertainty in the market whilst these changes are being implemented. It will take some time before we understand all the implications of unbundling payments for research from execution arrangements.

We hope you find these comments useful and please do not hesitate to contact me if you have any further questions.

Kind regards

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