What now for research analysts?

David Enticknap writes about the potential impact of the Investment Research Review on the UK equity landscape.

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The *Investment Research Review*, led by Rachel Kent in July 2023 followed extensive research and a request for input from a broad list of industry participants on the sell side, buy side, and academia. The report was endorsed by the chancellor during his Mansion House speech on 10th July 2023 and the FCA has stated its intention to work on the recommendations.

The report is targeted at addressing the shortcomings of MiFID II that absorbed much intellectual bandwidth during the mid-2010s. MiFID was well-intentioned as it related to investment research, aimed at more transparency on payment, but had some unintended consequences: a reduction in small cap coverage and overall research budget, as asset managers were forced to unbundle and took the cost of research onto their P&Ls.

This was exacerbated by the continued bundled environment in the US, and the regulations that prohibited asset managers from paying research providers directly for their research. Although the Securities and Exchange Commission issued an exception to allow this on a temporary basis, their stated intention to not renew this 'no-action letter' earlier this year threw a hand grenade into industry thinking. This decision was undoubtedly one of the drivers behind the Rachel Kent review; attendees at Substantive Research's 'Unbundling Uncovered' conference in November 2022 were speculating on the future with no firm conclusion on how to address the potential fallout.

Three of the seven main recommendations of the review relate to regulations and are welcome, but their impact is intangible; a code of conduct for sponsored research, a review of the regulatory regime and a tweak to the restrictions around IPO research that has slowed the IPO pipeline and made the UK uncompetitive. The first four recommendations are, however, likely to have a more substantive impact on the provision of research.

Contracted insights

Firstly, the establishment of an independent research platform is likely to increase the quantum of research in the market, particularly in the small cap space. The UK research market has contracted significantly over the last eight years, demonstrated by the reduced participation in the Extel (now II) UK SMID survey of research providers. Sell-side engagement has also declined as some significant players have struggled to survive on small-cap coverage alone and have had to broaden their coverage or product suite. For example, Liberum, Canaccord Genuity, N+1 Singer and even Peel Hunt have dropped in the rankings in 2023.

Internal or external?

The opportunity to re-bundle will be welcomed by many but it may not be the panacea. Removing the requirement to unbundle will permit flexibility, but even the tweak to MiFID

II in 2022 to exempt small-cap companies from the unbundling rules did not have the required impact; bundled payments does not necessarily mean more research into small-cap companies. Asset managers have yet to declare their intentions around re-bundling and their asset owners may be unhappy about new charges for research. Will research budgets increase again? The hope is that asset managers will look to improve their profitability by removing the costs from their P&L. They have also built up internal research teams, and these may be wound down since they are more expensive and less flexible than paying third-party research providers. The internal research is also, of course, kept in-house and not available to the market.

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The retail effect

The third recommendation relates to retail investors and permitting broader access. This may be executed through the research platform but should elicit greater interest in covered issuers and improved liquidity.

Brain drain

The final of the four recommendations is the involvement of academic institutions. MiFID II has caused a juniorisation of the research function as senior equity analysts leave the industry, migrate to become IROs, join the buy side or become independent research providers. If buy-side firms wind down their internal research teams, there could be a glut of analysts on the market but the creation of incentives to encourage recruitment to the industry would be beneficial.

In summary, the investment review is a huge positive for the UK investment research industry and could halt the systemic decline of the analyst function. A continued competitive environment enables us to recognise excellence in the industry, celebrate success and provide a much-needed service to covered companies. ■