Bundesverband der Wertpapierfirmen e.V.
Friedrichstraße 52, 60323 Frankfurt/Main

European Commission

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Capital markets – research on companies seeking alternative financing (updated rules in light of COVID-19)

Draft delegated directive - Ares(2020)3914669

Dear Sir, dear Madam,

the Bundesverband der Wertpapierfirmen e.V.(bwf) is a trade association representing the common professional interests of securities trading firms, market specialists (market makers) at the securities exchanges throughout Germany and other investment firms.[1] In this capacity, we expressly welcome the possibility to comment on the draft COMMISSION DELEGATED DIRECTIVE (EU) …/… amending delegated directive (EU) 2017/593 as regards the regime for research on small and mid-cap issuers and on fixed-income instruments to help the recovery from the COVID-19 pandemic.

General remarks

While bwf emphatically supports the proposed delegated directive which intends to allow again the offering of research as a bundled service which is paid through execution fees for securities issued by small and mid-cap companies, we would like to note that the issue which is addressed by the proposal, has – contrary to what the title of the initiative suggests – no significant nexus with the COVID-19 pandemic. In fact, the problems arising from this severe market structural change became evident long time before with the entering into force of MiFID II.

Furthermore, classification of research as an *"inducement"* and the prohibition of paying for research through execution fees (the *"unbundling rule"*) were introduced in the course of MiFID II legislation without a sound legal basis in the

[1] bwf is listed on the EU register of interest representatives under the ID 258694016925-01.

“Level I” text. Over the recent years, the provision had a strong damaging market-structural effect, in particular but not only on SME companies.

Therefore, while we fully support the initiative, we would have preferred a general lift of the unbundling provision which definitely did do more harm than good to the attractiveness of the European capital market.

This said, we would like to comment on certain aspects of the proposed delegated directive as follows:

1. Ex-ante agreement between investment firm and research provider

We think that the mandatory ex-ante agreement between the investment firm and the research provider which is expressly characterized in the explanatory memorandum as a “counter-balancing measure” would create an unnecessary administrative burden without creating a tangible regulatory benefit.

From an economic point of view, bundling the execution of orders with the provision of research is a service enhancement, just like any other possible enhancement, e.g. working an order *“carefully at market”* (either by a human trader or by employing an algorithm), smart order routing or providing a low latency trading environment. While the investment firm decides about at which price it wants to offer such service enhancements and the client can compare these prices to the price of basic *“plain vanilla”* or *”no frills”* execution services. We cannot see any convincing reason why there should be a higher level of regulatory concern and therefore more demanding regulatory requirements for bundling execution services with the provision of research than for any other possible execution service enhancement.

1.1. Conceptional problems of the agreement

Furthermore, the concept does not seem to be sufficiently flexible to reflect different market structures. In particular, it assumes that the research provider always is a third party to the investment firm and its clients which is not necessarily the case. Investment firms who offer order execution services might also have an in-house research department. In the latter case, it is completely unclear, how the mandatory provision of an ex-ante agreement shall be fulfilled when order execution and the production of research take place within the same company.

Also were the investment firm and the research provider are different entities, it remains blurred how such an agreement shall be administered in practice. In particular, the demand that the agreement shall identify which part of the joint payment is attributable to research, would require that the order executing investment firm would disclose its execution fees to the research provider, which we think is completely

unfeasible and would be clearly inappropriate. Even more, if the investment firm buys research from different sources, which it provides to clients as a single bundled execution service. In this case, the investment firm would have to disclose information relevant for competition among the different research providers which raises data-protection and other issues. Last but not least, it remains indistinct which information the investment firm would be required to disclose to its client in which detail and in which frequency?

1.2. Attributable costs

Under the assumption that an investment firm charges its clients an "all in" for order execution and the provision of research, while carrying the cost of the production of research either by paying a third party research provider (usually on a retainer/subscription basis) or by financing an in-house research department, an ex-ante identification of the part of the bundled execution fees which is attributable to research would be practically an impossible task because it the proportion is usually subject to constant changes which are not sufficiently predictable. While the production of research, no matter whether the investment firm buys it from an external provider or whether it operates an in-house research department is very much a calculation determined by fixed cost. In the contrary, order execution contains variable cost components, in particular in form of trading venue fees to a much higher extent. Consequently, the percentage of bundled fees charged by the investment firm would only remain constant, if trading volumes do not change. However, this is not the case; e.g. trading volumes have increased very significantly in the course of the COVI-19 pandemic.

However, theoretically, a constant share of payment for research could be achieved, if the investment firms would pay the research provider a pro rata to execution fees received from its clients.[2] Since this would require that the investment firm discloses its execution fee revenues on a continuous basis to one or more research providers in a verifiable form and in reverse the research provider by accepting this "success based" pricing would absorb the business risk arising from the execution business of the investment firm, such a concept can be ruled out as completely unfeasible for economic as well as legal reasons.

Furthermore, also from the perspective of an individual client, the information, which percentage of the bundled execution fee can be arithmetically attributed to research would not provide a meaningful information. Clients with very different execution volumes might have

[2] In the case of in-house production of research a transfer pricing model would have needed to be implemented.

access to the same pool of research published and a new client might consume the research provided for several weeks or even month before placing his first order with the investment firm.

For the reasons presented above, we are emphatically convinced that the ex-ante agreement between an investment firm and one or more research providers in the proposed form is neither necessary nor feasible and the provision should be removed from the draft delegated direction. However, if no political consensus could be obtained at this point, at least the completely impractical and meaningless concept to disclose attributable pro rata research costs contained in the bundled execution fees a firm charges to its clients should be given up. – Otherwise, we fear that this desirable legislative project will fail from the beginning due to a lack of practical applicability.

2. Threshold of EUR 1 billion market capitalization

As mentioned before, from our point of view, the introduction of the *"unbundling rule"* had negative effects for the Union's securities market as a whole and consequently should be removed completely.

In this context, due consideration should be given to the avoidable administrative burden which a *"split concept"* creates from an operational point of view: From a trading perspective, implementing different policies in dependence of market cap (based on the proposed EUR 1 billion threshold) would lead to additional administrative and compliance costs. Actually, an account duplication/segregation into bundled and unbundled accounts with the same counterparties/asset managers would have to be implemented. Furthermore, either systematically or manually (by checking the respective 12 month market cap) a decision whether to book against the bundled or unbundled account has to be taken on a *"per trade"* basis. This will increase settlement complexity (cancellation/re-bookings) and infrastructure costs (costs for data, costs for the technical integration into all execution channels such as high touch, low touch, program trading).

However, if a general lifting of the current "unbundling rule" would be not politically feasible, we think that the proposed threshold of EUR 1 billion market capitalization could be regarded as an appropriate calibration and a practical way forward in principle. However, we think that certain technical aspects regarding the calculation of this threshold still need to be reassessed before finalizing the proposed legislation.

First, to our understanding, the threshold shall not apply to fixed income instruments. This should be clarified.

At the moment, it remains unclear to us whether the threshold of EUR 1 billion during the proposed 12 months monitoring period should be applied on a day by day basis (which would mean that an issuer would disqualify for the

application of the exemption if the threshold is exceeded on a single day) or as an average. Clearly, we would prefer the latter. It should be also clarified whether the investment firm or the research provider shall be responsible for the observation and compliance with the threshold value.

Furthermore, we are of the opinion that the proposed provision that the backward-looking observation period shall start with the *"proceeding"* of the research would unnecessarily complicate the process and would result in a costly administrative burden since it would require an individual calculation and documentation (which also needs to be audited) depending on the date a research report is published (whereby the prove of evidence on which particular date a research report was provided, would create an additional administrative challenge). We therefore strongly suggest that the relevant observation period should be rather the calendar year proceeding the provision of the research than an individual twelve month period determined by the *"proceeding"* of the research report.

The proposed event-based twelve months period not only would be unnecessary costly to calculate and to document, it would also inherit the danger that research providers would hesitate to produce research for issuers with a market capitalization close to the threshold. Since the production of research reports usually takes weeks or even months, a research provider and the investment firm would have to face the danger that a research report might not be eligible for being distributed as bundled service, because the threshold on market capitalization was exceeded during the production of the report. We think that this would be a clearly undesirable outcome and another reason to refer to the preceding calendar year (or on an average value of an even longer observation period).

Finally, it would be helpful, if some guidance would be given by the legislation, which data sources would be eligible for the calculation of the threshold. Here, it is important, that firms can rely on data which is easily available at reasonable costs.

3. Bundling of execution fees with other services

The Commission clarifies in recital 2 of the proposal that it is the legislative intent to help issuers to connect with investors, to increase the visibility of issuers and thus to ensure a sufficient level of investment and liquidity.

We think that these goals can be best achieved, if – aside from research – additional corporate access services (e.g. individual *"1:1"* meetings with management, field trips, *"concierge"* services, participation in road shows etc.) would be allowed to be bundled with execution fees. Currently, corporate access services are also regarded to be inducements and their provision is only allowed, if firms providing these services charge them to their clients on an individual basis.

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Since research and corporate access services are complementary products from an investor's point, to allow the bundling of a *"package"* of research provision with corporate access services would be only consequent and could significantly help to achieve the legislative objectives.

We have no objection to the publication of our opinion, including the personal data contained in it or on the letterhead. Please do not hesitate to contact us if you have any questions regarding our comments or require further coordination.

Yours sincirely,

Michael H. Sterzenbach
Secretary General