

## **Appropriate Requirements for third party payments (inducements) under MiFID II**

Proposed restrictions for the use of research would constrain capital market access of small and medium sized enterprises

## Summary

Bank finance has traditionally been the major source of finance for small and medium sized enterprises in Europe. However, due to stricter regulatory requirements especially concerning capital and liquidity reserves availability of bank lending will become more difficult in future. Therefore, alternatives to bank lending should be promoted in order to diversify finance and to reduce the dependency of SMEs on credit supply. This should include financing via an initial public offering (IPO).

Politicians and regulators increasingly acknowledge the importance of capital markets as source of long-term financing. This is the core statement of the European Commission in its communication on Long Term Financing of the European Economy released in March 2014. These political efforts – which Deutsches Aktieninstitut<sup>1</sup> strongly supports – should be accompanied by an appropriate regulatory framework.

ESMA's draft technical advice relating to the reviewed Market in Financial Instruments Directive (MiFID II) and its proposal to restrict the usage of financial research provided as a non-monetary benefit would seriously deteriorate capital market access of small and medium sized companies. For institutional investors financial research is the basis of the decision to invest in a share. The rules proposed by ESMA will especially impact negatively the availability of research regarding shares of small and medium sized companies. This would be to the clear disadvantage of smaller issuers as it would become much more difficult for these companies to raise funds on stock exchanges. Therefore, the rule proposed by ESMA would contradict the political efforts to improve small and medium sized companies' capital market access and should be abandoned.

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<sup>1</sup> Deutsches Aktieninstitut represents the entire German economy interested in the capital markets. Its about 200 members are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt am Main, Brussels and in Berlin.

## Our Remarks in Detail

According to Art. 24 of MiFID II persons providing portfolio management and investment advice on an independent basis should only accept minor non-monetary benefits. In this context ESMA intends in its draft technical advice to prohibit the reception of tailored research which is provided e.g. by brokers for free (see p. 118 et seq. in ESMA's consultation paper). ESMA justifies this strict rule with conflict of interests which might occur to the disadvantage of the clients. Irrespective of the prohibition ESMA concedes that the portfolio manager is allowed to acquire research provided that there is a "separate contractual agreement between themselves and the broker for the provision of such research [in place] that included a reasonable level of payment for that service."

In order to create a level-playing-field ESMA also recommends to align the rules regarding research with other relevant regulations, especially those related to asset management under UCITS and AIFMD. If this recommendation was followed by the EU Commission access to research would become very difficult for the whole mutual funds industry.

The lack of research would have negative consequences for share investments by investment funds. Especially the investment in SME shares would be affected negatively. ESMA should take note of the fact that there is already little research coverage of smaller issuers by professional analysts due to the low liquidity in the respective shares. ESMA's proposals would worsen this situation so that (institutional) investors would even invest less funds in shares of smaller issuers. A vicious circle would be created: Less coverage reduces information and thus investment in SME shares. Little investment would decrease liquidity further and would reduce the level of investment again. As a consequence, it would get even more difficult for small and medium sized companies to access successfully the capital market via an IPO.

Sound research provided by professional analysts is a crucial source of information for the portfolio manager in its decision to acquire a share of a smaller issuer against the background of well-balanced risk-return-considerations. The essential economic function of research should be acknowledged and not hampered by inappropriate regulation as proposed by ESMA. ESMA should also be aware that by nature the volume of assets under management of small- and mid-cap investors is low compared to funds which invest in blue chip companies. Hence, return which can be generated from SME investment funds is also lower.

Therefore, it is questionable whether portfolio management of smaller issuer funds can be run profitable in future if the research which is a prerequisite for a sound investment decision must be purchased. We are very concerned that many asset management companies will decrease their investment levels in shares of smaller issuers. As a consequence, important investors would decline from buying SME shares which would make it very difficult or impossible for small and medium sized companies to access successfully the capital markets via an IPO or the issuance of shares.

The problem is aggravated by the fact that research providers will adjust their supply according to the lower demand. Therefore, coverage of smaller issuers – which is already very low – would decrease further. As a consequence, IPOs and being public of smaller companies would become much more difficult than it is already today. Overall, the prohibition of exclusive and free of cost research as proposed by ESMA would contradict political efforts to improve capital market financing of small and medium sized companies, what was declared by the European Commission as an important political objective in its communication on Long Term Financing of the European Economy.

In the interest of the European economy and the availability of capital market financing it is important to abandon the rules regarding research as proposed by ESMA. We also do not understand the reasoning behind this proposal. Especially regarding shares of smaller issuers the research provided is a very important information which is used by portfolio managers in drawing a well-informed (i.e. efficient) investment decision in the interest of their clients. Possible incentives to behave to the detriment of the clients should be addressed by other measures, e.g. the best execution rule. Last but not least, the interpretation of ESMA regarding the level-1-text of the MiFID II is inappropriately far-reaching. Such an extensive prohibition of the provision of research was certainly not in the legislator's intention.

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