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ESMA Issues Working Paper on the Impact of the MiFID II Research Unbundling Provisions on SMEs

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March 4, 2021 TO: ICI Global Members SUBJECTS: International/Global MiFID, EMIR, AIFMD, UCITS V RE: ESMA Issues Working Paper on the Impact of the MiFID II Research Unbundling Provisions on SMEs

The European Securities and Markets Authority (ESMA) recently released a working paper (ESMA Working Paper) on the impact of the Markets in Financial Instruments II (MiFID II) “research unbundling” provisions on small and medium-sized enterprises (SMEs).^[1] The research unbundling provisions impose a requirement upon entities that provide both research and brokerage or other investment-related services (i.e. investment firms) to asset managers to separately identify the cost of the research they provide. This requirement results from the MiFID II mandate that asset managers must pay, either directly or by passing on the charge to their clients, for research they obtain.^[2] The goals behind implementing the research unbundling provisions included reduction of the risk of conflict of interest and of the risk of overproduction of research.^[3]

ESMA released this working paper to address concerns that the MiFID II research unbundling provisions have had detrimental effects, particularly on SMEs, on the availability and quality of research on EU companies and on financing conditions.

Overview

Since the implementation of the MiFID II unbundling provisions in January of 2018, market players and academics have engaged in discussions and released commentary on the impact of the provisions on research producers (typically investment firms), research subjects (larger firms and SMEs), and research consumers (asset managers). The literature that has been produced on this issue is largely varied due to the diversity in information sources (i.e., market surveys in which respondents were on the sell-side versus the buy-side) and the range of entities which produced and processed the findings (i.e., market players versus academics).^[4] The existing academic literature tends to indicate more neutral findings, which is more in line with the findings of the ESMA Working Paper.^[5]

The ESMA Working Paper adds to the existing literature in numerous ways. First, the ESMA Working Paper specifically addresses the impact on SMEs in comparison to larger firms.^[6]

Second, the ESMA Working Paper expands on recent efforts of assessing the impact on the unbundling provisions on the liquidity and financing conditions of companies by analyzing a variety of complementary market conditions, including tightness, depth, and cost. Third, the ESMA Working Paper takes a long-term perspective on the impact of the provisions on sell-side research quality and quantity. In doing so, the ESMA Working Paper mentions other market developments that may have affected the supply of sell-side research in the past few years, including digitalization, industry consolidation, and a decreasing number of listings.[\[7\]](#)

As described in more detail below, the ESMA Working Paper finds that SMEs have not been disproportionately affected, in comparison to larger firms, by the implementation of the MiFID II research unbundling provisions.[\[8\]](#)

Conclusions

The econometric analysis presented in the ESMA Working Paper suggests that, *when compared to larger firms*:

- the quantity of research per SME is overall unchanged – or at most only slightly declined.
 - When looking at all companies, including larger firms and SMEs, the quantity of the research produced by sell-side analysts has generally declined since the application of MiFID II, by around one analyst per company. The ESMA Working Paper suggests that it is reasonable to interpret this reduction as a result of increased efficiency in research production.[\[9\]](#)
 - SMEs have not been disproportionately affected in terms of the number of analysts following each company.[\[10\]](#) Data indicates that the average number of analysts covering each SME has remained stable, suggesting that the research intensity for SMEs has remained largely unchanged since the application of the MiFID II provisions. This seems to indicate that the slight overall reduction in research intensity across the industry between 2006-2019 can be attributed mainly to large companies.[\[11\]](#) The findings suggest that the steady trend of consolidation in the research industry is more heavily concentrated on companies other than SMEs.[\[12\]](#)
- the probability of an SME completely losing coverage has not increased.
 - In between 2006-2019, there was a rise in the companies that stopped receiving earnings-per-share (EPS) estimates from any analysts, and presumably lost coverage. However, this trend began back in 2012 – preceding MiFID II.[\[13\]](#) Both large and SME companies across the EU actually gained analyst coverage during 2018 before sharply decreasing at the end of 2019. Not enough information exists to conclude that these changes were driven by MiFID II.[\[14\]](#)
 - The collected data does not suggest that the introduction of MiFID II has led to a significant difference in the number of analysts producing EPS estimates per company.[\[15\]](#)
- the quality of SME research has not worsened, relative to larger firms.
 - Data suggests a weak trend towards *improved* accuracy of EPS forecasts after the implementation of MiFID II. However, this trend seems to be more pertinent for larger firms and, nevertheless, began in 2012 – several years prior to MiFID II.[\[16\]](#)
 - The ESMA Working Paper concludes that the overall quality of the research has remained broadly stable after MFID II.[\[17\]](#)

- SME liquidity conditions have worsened in terms of tightness but not in terms of depth, relative to larger firms.^[18]
 - The ESMA Working Paper finds that the liquidity and financing conditions have worsened for SMEs relative to larger firms, since the application of the MiFID II unbundling provisions, in terms of tightness (measured by bid-ask spreads) and cost of debt. No significant difference is found in terms of depth (measured by the Amihud illiquidity ratio and the turnover ratio).

The ESMA Working Paper acknowledges that SMEs, in comparison to larger companies, continue to have a lower quantity and quality of investment research, more limited secondary market liquidity, and higher probability of losing coverage. However, this disparity was neither instigated nor exasperated by the application of MFID II unbundling provisions.^[19] The ESMA Working Paper concludes that the MiFID II research unbundling provisions have had a fairly neutral effect on SMEs, particularly in comparison to their effect on larger companies.^[20]

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endnotes

^[1] ESMA Working Paper No. 3, MiFID II research unbundling: assessing the impact on SMEs (February 17, 2021), *available at* https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1269_research_unbundling.pdf. Note, in December 2020, the European Council approved the Capital Markets Recovery Package which included an exemption to the unbundling provisions for investment research on issuers whose market capitalization did not exceed EUR 1 billion during the preceding 36 months, subject to certain conditions.

^[2] *Id.* at 4.

^[3] *Id.* at 5. Note, the working paper, by its nature, does not officially represent the views of ESMA.

^[4] *Id.* at 5-6.

^[5] Recent academic literature has indicated a general decline in the number of analysts covering EU firms, an increase in the accuracy of analyst forecasts, and a moderately negative impact on liquidity since the implementation of MiFID II. The claims of public authorities have been more varied, with some suggesting little to no overall effect while others indicating an impact on the quality or quantity of research within their jurisdiction. Market participants have published claims, based on market surveys, that the unbundling provisions have led to poorer quality research, a reduction on the total amount of research production, and fewer analysts producing research on companies. *Id.* The market surveys on which the industry members have relied on are varied based on their respondents. This is evident in CFA's 2019 findings that "buy-side professionals mostly believe that research quality is unchanged, but sell-side respondents are generally more pessimistic, with 44% believing that research quality has decreased overall...Less than 10% of both buy-side and sell-side respondents believe research quality has increased." *Id.* at 17.

[6] It is important to note that the research conducted by ESMA distinguishes SMEs from other companies by the legal and supervisory frameworks that apply to them, as opposed to defining SMEs by more arbitrary market conditions. If a firm satisfies the regulatory definition of a SME, there are different material consequences for the capital requirements faced by banks providing funds to the company and there are fewer disclosure requirements for SMEs under the Prospectus Regulation and Accounting Directive. *See Id.* at 6.

[7] *See Id.*

[8] *See Id.* at 17.

[9] *Id.* at 14.

[10] *Id.* at 15.

[11] *Id.* at 9.

[12] *Id.*

[13] *Id.*

[14] *Id.* at 10.

[15] *Id.* at 8.

[16] *Id.* at 11.

[17] *Id.* at 15.

[18] *Id.* at 17.

[19] *Id.*

[20] The paper further indicates that there remain several subsets of the EU market that have not yet been extensively studied in terms of differential impact, such as between buy-side and sell-side analysts and different types of research like unsolicited research versus sponsored. *Id.* at 17. There remains room for more discourse and research, particularly considering indication from the European Commission that unbundling rules may further evolve in the future. *Id.* at 5.