
Staff Report on the Issues Affecting the Provision of and Reliance Upon Investment Research Into Small Issuers

As Required by Section 106 of the Consolidated Appropriations Act, 2021



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I. Introduction

A. Congressional Mandate

Section 106 of the Consolidated Appropriations Act, 2021¹ (“Section 106”) requires the U.S. Securities and Exchange Commission (“SEC” or “Commission”) to submit to Congress a report that includes a study evaluating the issues affecting the provision of and reliance upon investment research into small issuers (“Report”).

Specifically, Section 106 provides:

(a) **STUDY REQUIRED.** —The Securities and Exchange Commission shall conduct a study to evaluate the issues affecting the provision of and reliance upon investment research into small issuers, including emerging growth companies and companies considering initial public offerings.

(b) **CONTENTS OF STUDY.** —The study required under subsection (a) shall consider —

- (1) factors related to the demand for such research by institutional and retail investors;
- (2) the availability of such research, including —
 - (A) the number and types of firms who provide such research;
 - (B) the volume of such research over time; and
 - (C) competition in the research market;
- (3) conflicts of interest relating to the production and distribution of investment research;
- (4) the costs of such research;
- (5) the impacts of different payment mechanisms for investment research into small issuers, including whether such research is paid for by —
 - (A) hard-dollar payments from research clients;
 - (B) payments directed from the client’s commission income (i.e., “soft dollars”); or
 - (C) payments from the issuer that is the subject of such research;
- (6) any unique challenges faced by minority-owned, women-owned, and veteran-owned small issuers in obtaining research coverage; and

¹ Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, Div. Q, tit. I, § 106, 134 Stat. 1182 (2020).

(7) the impact on the availability of research coverage for small issuers due to —

(A) investment adviser concentration and consolidation, including any potential impacts of fund-size on demand for investment research of small issuers;

(B) broker and dealer concentration and consolidation, including any relationships between the size of the firm and allocation of resources for investment research into small issuers;

(C) Securities and Exchange Commission rules;

(D) registered national securities association rules;

(E) State and Federal liability concerns;

(F) the settlement agreements referenced in Securities and Exchange Commission Litigation Release No. 18438 (i.e., the “Global Research Analyst Settlement”); and

(G) Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, as implemented by the European Union (“EU”) member states (“MiFID II”).

(c) REPORT REQUIRED. —Not later than 180 days after the date of the enactment of this Act, the Securities and Exchange Commission shall submit to Congress a report that includes—

(1) the results of the study required by subsection (a); and

(2) recommendations to increase the demand for, volume of, and quality of investment research into small issuers, including emerging growth companies and companies considering initial public offerings.²

B. Overview

Investment research (also referred to as “research” hereinafter) can be created and provided by broker-dealers or independent research providers for use by investment professionals, which may include professionals at other broker-dealers, investment advisers, insurance companies, pension funds and other institutional investors.³ Some of these end users

² *Id.*

³ See generally Larry Harris, CFA Institute, Chapter 13: Structure of the Investment Industry (2014), <https://www.cfainstitute.org/-/media/documents/support/programs/investment-foundations/13-structure-of-the-investment-industry.ashx> (discussing buy-side and sell-side firms); see also Janelle Veasey & John B. Mason, Refinitiv, Connected Data: Challenges Remain for Buy-Side Market and Reference Data Strategies (2021), https://www.refinitiv.com/content/dam/marketing/en_us/documents/reports/connected-data-buy-side-firms-

of research, such as investment advisers, may alternatively conduct research in-house for their own consumption. Broadly speaking, research and its prompt and fair dissemination to investors has been recognized as valuable to an efficient system of securities markets.⁴ There is substantial evidence that research coverage of issuers is beneficial.⁵ Research coverage may be particularly important for a small issuer that seeks to increase its stock liquidity or gain investors' recognition.

At the same time, however, the provision of research may have associated conflicts of interest that may create incentives for firms providing research (“analyst firms”) and analysts⁶ to issue biased research. For example, analysts may issue favorable research to retain or generate investment banking business, particularly if their compensation or status within a firm are tied to investment banking revenues.⁷ Various legislative and regulatory measures have been taken in the United States to, among other things, address these conflicts of interest, with a view to improving the quality of research and restoring public confidence. Additionally, the EU enacted MiFID II in 2018 to, among other things, address potential conflicts of interest associated with money managers⁸ purchasing research.

As required by Section 106, Commission staff has conducted a study evaluating the issues affecting the provision of and reliance upon investment research into small issuers.⁹ This

[ebook.pdf](#) (noting that buy-side firms include hedge funds, insurance companies, mutual funds, pension funds and sovereign organizations).

⁴ SEC, Future Structure of Securities Markets, 37 Fed. Reg. 5286 (Mar. 14, 1972) (“1972 Commission Statement”).

⁵ Academic literature has shown, for example, that (1) research coverage of an issuer may affect the liquidity of its stock, and (2) research analysts provide an external governance mechanism by monitoring issuers' management. See, e.g., Robert C. Merton, *A Simple Model of Capital Market Equilibrium with Incomplete Information*, 42 J. FIN. 42, 483 (1987) (“Merton”); Rustom M. Irani & David Oesch, *Analyst Coverage and Real Earnings Management: Quasi-Experimental Evidence*, 51 J. FIN. & QUANTITATIVE ANALYSIS 589, 590 (2016) (“Irani & Oesch”). For a detailed discussion of the benefits of research coverage, including the benefits of multiple analysts covering a single issuer, see *infra* Section II.B.

⁶ Research is created by financial market professionals commonly referred to as “research analysts,” or simply “analysts.”

⁷ For a discussion of analysts' conflicts of interest related to research, see *infra* Section III.

⁸ Money managers may also be referred to as “asset managers” or “portfolio managers.”

⁹ For purposes of this Report, “small issuers” are issuers that have equity securities listed on national securities exchanges that are registered with the SEC under Section 6 of the Securities Exchange Act of 1934 (“exchange-listed stocks”) and market capitalization of less than \$250 million. There is also a definition of “smaller reporting company” in the SEC rules and regulations, which covers issuers with a public float of less than \$250 million or with less than \$100 million in annual revenues and no public float or public float of less than \$700 million. See SEC, *Smaller Reporting Company Definition*, 83 Fed. Reg. 132 (Jul. 10, 2018). The staff selected the definition of “small issuers” that use the market cap metric to be consistent with the definition of “smaller public companies” in the SEC Small Business Advocate Act of 2016, and the scope of issuers served by the SEC's Office of the

Report outlines the results of the staff’s study evaluating these issues based upon available data, as well as the staff’s recommendations for increasing the demand for, volume of, and quality of investment research into small issuers.

The staff conducted an extensive review of publicly available sources¹⁰ and engaged in data analysis of research coverage trends of issuers generally and trends by issuer size¹¹ to evaluate whether, and to what extent, various factors have impacted research coverage of small issuers. The staff’s evaluation suggests that a number of factors may have impacted research coverage of small issuers, including legislative and regulatory measures, MiFID II and other variables, such as the rise of client commission arrangements (“CCAs”), a decline in the overall number of IPOs until 2020,¹² falling equity commissions, fewer institutional investors that invest in small issuers, a shift from active to passive investment strategies, an increase in reliance on in-house research and an increase in alternative data sources. It is difficult to isolate

Advocate for Small Business Capital Formation. See Pub. L. No. 114-284, 130 Stat. 1447 (2016) (codified at 15 U.S.C. § 78qq(a)(2)(A)(i)); see also Off. of the Advoc. for Small Bus. Cap. Formation, Annual Report for Fiscal Year 2020, SEC, 2 (2020) (“OASB 2020 Annual Report”), <https://www.sec.gov/files/2020-oasb-annual-report.pdf>. Conversely, all other issuers are considered “large issuers.”

¹⁰ The staff reviewed academic literature, studies, articles and other publicly available sources discussing, among other things, the impacts of legislative and regulatory measures on research coverage and the impacts of MiFID II on payment mechanisms for research and research costs. See *infra* Sections IV.B and V.C. The staff’s review of publicly available sources did not find materials that addressed some of the factors identified in Section 106, including, for example, factors related to the demand for research of small issuers by institutional and retail investors; unique challenges faced by minority-owned, women-owned, and veteran-owned small issuers in obtaining research coverage; and impact on the availability of research coverage for small issuers due to investment adviser and broker-dealer concentration and consolidation. For a general discussion of some of these factors in a broader context (i.e., capital formation), see Off. of the Advoc. for Small Bus. Cap. Formation, Annual Report for Fiscal Year 2021, SEC (2021) (“OASB 2021 Annual Report”), <https://www.sec.gov/files/2021-OASB-Annual-Report.pdf> (discussing minority-owned and women-owned business formation and ownership trends and challenges as well as investors’ increasing focus on environmental, social and governance considerations for public companies); Sophia Kunthara, *The Market Minute: A Historic Year (So Far) for Woman-Led IPOs, But There’s a Ways to Go*, CRUNCHBASE NEWS (Aug. 11, 2021), <https://news.crunchbase.com/news/the-market-minute-a-historic-year-so-far-for-women-led-ipos-but-theres-a-ways-to-go/> (discussing challenges that women entrepreneurs face in raising funds for their businesses).

¹¹ See *infra* note 14 (discussing the scope and limitations of the staff’s data analysis). Although the data was extensive and the staff was able to consider most of the factors identified in Section 106, the data was limited in several respects. For example, while emerging growth companies (“EGCs”) disclose their EGC status in their SEC filings, this information was not available in the two databases that the staff used for this Report. The available data was also limited to only issuers that have already completed initial public offerings (“IPOs”) and issuers with exchange-listed stocks. Accordingly, the staff’s evaluation of the data did not cover EGCs and companies considering IPOs specifically.

¹² There has been a noticeable increase in IPOs, including IPOs of small issuers, in 2020 and 2021. See OASB 2021 Annual Report, *supra* note 10 (including charts that show a marked increase in IPOs, including IPOs of small issuers, in 2020 and the beginning of 2021); see also Sanghamitra Saha, *2021 Likely to be a Record Year for IPOs: ETFs to Win*, NASDAQ, Oct. 22, 2021, <https://www.nasdaq.com/articles/2021-likely-to-be-a-record-year-for-ipos%3A-etfs-to-win-2021-10-22> (discussing the IPO market in 2021).

with precision the individual effect of legislative and regulatory measures, or any individual factor, on the research coverage of small issuers, particularly since certain declining trends in research coverage may have existed before some of these measures.¹³ Thus, the extent of the impact of these measures have had to date is unclear.

Further, the staff observed a number of trends based on its data analysis.¹⁴ For instance, small issuers are less likely than large issuers to be covered by research coverage. Specifically, the availability of research coverage and the number of analysts covering an issuer correlate with market capitalization.¹⁵ In recent years, approximately 60% of small issuers have received research coverage while approximately 90% of large issuers have received coverage.¹⁶ Furthermore, small issuers received coverage by approximately two analyst firms on average while large issuers received coverage by approximately nine analyst firms on average.¹⁷

In light of the staff's findings, the staff recommends that the staff continue to monitor research trends, with the goal of furthering the staff's (1) evaluation of factors that may impact the provision of and reliance upon research into small issuers and (2) consideration of what, if any, potential actions may be appropriate to increase the demand for, volume of, and quality of investment research into small issuers. As part of this evaluation, the staff recommends that the staff continue to engage with global regulators and industry participants to better understand any developments in the research marketplace.

This Report proceeds as follows: Section II provides an overview of research generally and explains its importance and benefits. Section III discusses the conflicts of interest related to research. Section IV describes the legislative and regulatory measures addressing such conflicts and their impacts on research coverage. Section V addresses payment mechanisms and costs of research, and the impacts of the EU's implementation of MiFID II on payment mechanisms and

¹³ See *infra* note 110 and corresponding text discussing decline in analysts and research coverage of small issuers before legislative and regulatory measures; see also *infra* note 170 discussing certain downward trends that existed before MiFID II.

¹⁴ In conducting the study, the staff relied primarily on two widely-used databases that contain, among other things, analyst estimates, financial information on public issuers and data on issuers with exchange-listed stocks. The staff focused its analysis of data in recent years (i.e., 2016 to 2020). See *infra* Section VI (discussing the scope and limitations of the staff's data analysis and research coverage trends).

¹⁵ Market capitalization, or "market cap," is the value of a corporation determined by multiplying the current public market price of one share of the corporation by the number of total outstanding shares. Off. of Inv. Educ. & Advoc., Market Capitalization, SEC, <https://www.investor.gov/introduction-investing/investing-basics/glossary/market-capitalization>. See *infra* Section VI.B (discussing research coverage trends of small issuers and large issuers).

¹⁶ See Figure 6a, *infra* Section VI.B.

¹⁷ See Figure 6b, *infra* Section VI.B.

research costs. Section VI includes the staff’s data analysis of research coverage trends. Lastly, Section VII contains the staff’s recommendations for increasing the demand for, volume of, and quality of investment research into small issuers, including EGCs and companies considering IPOs: specifically, the staff recommends that the staff continue to monitor research trends and evaluate these issues as part of its further consideration of what, if any, potential actions may be appropriate to increase the demand for, volume of, and quality of investment research into small issuers.

II. Importance and Benefits of Research

A. Research Generally

Research generally fits into one of three categories based on the type of firm that is involved in its creation and/or provision: (1) research provided by full-service broker-dealers, commonly referred to as “sell-side research,” often for consumption by others;¹⁸ (2) research created in-house by institutional money managers (who are typically investment advisers in the United States) to assist them with their own investment decision-making process, commonly referred to as “buy-side research”; and (3) research provided by firms that are neither, commonly referred to as “independent research.”¹⁹ As discussed further below, money managers in the United States may purchase sell-side or independent research with “soft dollars” (i.e., bundled commission payments using client assets to acquire brokerage and research services) or “hard dollars” (i.e., payments in cash for services such as research, which may include direct payments from a money manager’s own resources).

Many analysts specialize in a particular industry and provide research on a subset of issuers in that industry (“subject companies”) on an ongoing basis by, for example, publishing periodic written work product on the subject company. Such research may contain, for example, a narrative describing market developments, projections of financial metrics, a target price, and an overall rating or recommendation, such as buy, hold, or sell.²⁰ The exact items

¹⁸ “Sell-side research” is also referred to as proprietary or “Street” research.

¹⁹ Div. of Trading & Mkts., *Analyzing Analyst Recommendations*, SEC (Aug. 30, 2010) (“Analyzing Analyst Recommendations”), <https://www.sec.gov/tm/reportspubs/investor-publications/investorpubsanalystshtm.html>. “Independent research” is also referred to as “third-party research.” See *infra* Section V.A. This Report focuses on research concerning securities such as sell-side research and, to a lesser extent, independent or buy-side research as it responds most directly to Congress’s mandate in Section 106. While data concerning independent research is included in the figures in this Report and tables in the Appendix, data concerning buy-side research is excluded because it is typically not disseminated publicly or made available in commercial databases.

²⁰ See *Analyzing Analyst Recommendations*, *supra* note 19; Alastair Lawrence et al., *Investor Demand for Sell-Side Research*, 92 ACCT. REV. 2, 4 (2017) (“Lawrence et al.”) (noting that “forecasting earnings is prevalent because investors prefer analyst estimates to recommendations and target prices at earnings-related financial reporting events”).

included in this research, the terms used, and the meanings of these terms vary.²¹ The research can be published at any time, including, for example, in response to corporate events such as earnings releases.²² Analyst firms may limit the distribution of such research to institutional clients, but even in those instances, financial projections, target prices, and overall ratings are widely accessible through third-party data providers and the media.²³ Retail investors may incorporate such research into their investment decision-making process to resolve uncertainty about an issuer.²⁴ They may look to research for an interpretation of attention-grabbing events, such as media coverage about an issuer or bold predictions from other analysts.²⁵

Analysts may also perform tasks other than drafting and publishing written research. For instance, they may facilitate their institutional clients' access to subject companies' management by hosting conferences and arranging one-on-one meetings or conference calls.²⁶

²¹ Analyzing Analyst Recommendations, *supra* note 19. While definitions of certain terms vary among analyst firms, Financial Industry Regulatory Authority ("FINRA") Rule 2241(c)(2) requires analyst firms that are broker-dealers to clearly define in each research report the meaning of each rating in the system, including the time horizon and any benchmarks on which a rating is based. FINRA, Rule 2241(c)(2) (2015). Broker-dealers are subject to regulation under the Securities Exchange Act of 1934 ("Exchange Act") and the rules of each self-regulatory organization ("SRO") of which the broker-dealer is a member. Generally, all registered broker-dealers that deal with the public must become members of FINRA. *See* Section 15(b)(8) of the Exchange Act, 15 U.S.C. § 78o(b)(8), and Rule 15b9-1 under the Exchange Act, 17 C.F.R. § 240.15b9-1.

²² *See* Beyer et al., *The Financial Reporting Environment: Review of the Recent Literature*, 50 J. ACCT. & ECON. 296, 326-327 (2010) ("Beyer et al.") (reviewing academic literature concerning analysts' decisions on when to issue forecasts); Lawrence et al., *supra* note 20 (stating that "demand for analyst information on Yahoo Finance is highest on days with management guidance, earnings announcements, and Form 8-Ks" and "lower demand for analyst information following the release of Forms 10-Ks and 10-Qs"). FINRA Rule 2241(f) requires analysts to publish a report when terminating coverage of an issuer. FINRA, Rule 2241(f) (2015).

²³ *See, e.g.,* *Analysis Webpage for Alphabet, Inc.*, YAHOO FIN., <https://finance.yahoo.com/quote/goog/analysis/> (containing aggregated analyst estimates for a single issuer); *Upgrades/Downgrades*, WALL ST. J., <https://www.wsj.com/market-data/stocks/upgradesdowngrades> (listing upgrades and downgrades by analysts); *Street Notes*, BARRON'S, <https://www.barrons.com/topics/street-notes> (including short media summaries of certain analyst opinions).

²⁴ *See, e.g.,* Lawrence et al., *supra* note 20, at 3 (finding that retail investors' overall demand for analyst ratings and target prices is substantially higher than for analyst earnings and sales estimates and that small investors rely on analysts to interpret financial reporting information instead of reading SEC filings).

²⁵ *See id.* at 11 and 13.

²⁶ *See* Stephen Taub, *Hedge Funds Disdain (Most) Sell-Side Analysts. Here's Who They Actually Like.*, INST'L INV'R, Oct. 10, 2018, <https://www.institutionalinvestor.com/article/b1b9qqjbdrpc5b/Hedge-Funds-Disdain-Most-Sell-Side-Analysts-Here-s-Who-They-Actually-Like> ("[W]here the sell side is perceived to provide the most value to hedge funds is through corporate access – the meetings with corporate executives, field trips to see firm operations, and non-deal roadshows organized by sell-side firms on behalf of buy-side investors."); *see also* SEC, Selective Disclosure and Insider Trading, Exch. Act Rel. No. 43154 (Aug. 15, 2000), 65 Fed. Reg. 51716 (Aug. 24, 2000) (reshaping the ways in which issuers conduct their conference calls and meetings with analysts and investors).

Analysts may also make recommendations or offer opinions concerning subject companies in public appearances, such as radio, television or print media interviews.²⁷ Further, sell-side analysts who are associated with broker-dealers that provide investment banking services may, subject to regulatory requirements,²⁸ be involved in investment banking transactions.²⁹

B. Importance and Benefits of Research

Research and its prompt and fair dissemination to investors has been recognized as valuable to an efficient system of securities markets.³⁰ The Commission has frequently acknowledged the important role of research to U.S. capital markets, in particular its

²⁷ See SEC, Regulation Analyst Certification, Exch. Act Rel. No. 47384 (Feb. 20, 2003), 68 Fed. Reg. 9482, 9492 (Feb 27, 2003) (“Reg. AC Adopting Release”) (defining “public appearance” to mean “any participation by a research analyst in a seminar, forum (including an interactive electronic forum), or radio or television or other interview, in which the research analyst makes a specific recommendation or provides information reasonably sufficient upon which to base an investment decision about a security or an issuer”). See also *infra* Section IV.A.3 (discussing Reg. AC).

²⁸ See FINRA, Rule 2241 (2015), Supplementary Material .02, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2241>. Involving research analysts in the investment banking process creates conflicts of interest. Broker-dealers must identify and manage these conflicts pursuant to regulatory requirements. For a discussion of such conflicts of interest and regulatory requirements, see *infra* Sections III and IV, respectively.

²⁹ See Benjamin J. Catalano, *The Promise of Unfavorable Research: Ramifications of Regulations Separating Research and Investment Banking for IPO Issuers and Investors*, 72 BUS. LAW. 31, 32 (2016) (“Catalano”).

³⁰ See 1972 Commission Statement, *supra* note 4, at 5290 (“It is, therefore, the Commission’s premise that broad-based securities research and its prompt and fair dissemination to large and small investors is indispensable to an efficient system of securities markets.”); Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exch. Act Rel. No. 54165 (Jul. 18, 2006), 71 Fed. Reg. 41978 (Jul. 24, 2006) (“2006 Release”) (“Recognizing the value of research in managing client accounts . . . Congress enacted Section 28(e) of the Exchange Act . . .”); Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exch. Act Rel. No. 23170 (Apr. 28, 1986), 51 Fed. Reg. 16004 (Apr. 30, 1986) (“1986 Release”) (“In adopting Section 28(e), the Congress acknowledged the important service broker-dealers provide by producing and distributing investment research to money managers and created a safe harbor to permit money managers, in certain circumstances, to continue to use commission dollars paid by managed accounts to acquire research as well as execution services.”). See also Technical Comm., *Report on Analyst Conflicts of Interest*, International Organization of Securities Commissions (“IOSCO”) 2 (2003) (“IOSCO Report”), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD152.pdf> (“Information is the lifeblood of modern capital markets. The flow of timely and accurate information among market participants promotes investor confidence in the markets, which aids in the flow of capital to businesses. However, the volume and complexity of information and raw data which is available – including, issuer disclosure statements, economic and employment statistics from governments, and marketing and purchasing trend reports from private sources – can often be overwhelming and confusing for investors. As a result, research analysts play an important role in the relationship between companies and investors, both retail and institutional.”).

significance in discovering issuer information and sifting, digesting and transmitting it in a manner that may be used by investors.³¹

Investors may view research as an important component of the information environment and use accounting-based information (e.g., analyst forecasts, earnings announcements, earnings pre-announcements, management forecasts, SEC filings) for investment decisions.³² Further, academic literature has detailed the benefits of research coverage of publicly traded issuers. It has shown, for example, that (1) research coverage of an issuer may affect the liquidity of its stocks, and (2) research analysts provide an external governance mechanism by monitoring issuers' management.

1. Liquidity

Studies have shown that research coverage of an issuer is positively related to its stock liquidity³³ and that a reduction in research coverage of an issuer may reduce its stock liquidity.³⁴ For instance, one study found that issuers that lose analyst coverage for at least one year suffer a “significant deterioration in bid-ask spreads, trading volumes, and institutional

³¹ See, e.g., 1972 Commission Statement, *supra* note 4; 2006 Release, *supra* note 30.

³² See Beyer et al., *supra* note 22 (estimating the impact of various accounting-based sources of information based on data from 1994 to 2007 and finding that analyst forecasts constituted almost a quarter of the accounting-based information used by investors).

³³ See, e.g., Tung L. Dang et al., *Analysts and Stock Liquidity – Global Evidence*, COGENT ECON. & FIN. (2019), available at <https://www.tandfonline.com/doi/full/10.1080/23322039.2019.1625480> (finding that firms' analyst coverage is positively related to stock liquidity, which confirms “the notion suggested in previous studies that analyst activities provide public information that reduces information asymmetries between firms and market participants”); see also Beyer et al., *supra* note 22 (discussing empirical evidence finding that “firms with sustained improvements in analysts' ratings of disclosure quality . . . show an increase in stock liquidity, analyst following, institutional ownership, and stock performance”).

³⁴ See, e.g., Inv'r Advisory Comm., *Recommendation of the SEC Investor Advisory Committee Structural Changes to the US Capital Markets Re Investment Research in a Post-MiFID II World*, SEC, 3 (Jul. 25, 2019), <https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-research-post-mfid-ii-world.pdf> (“A reduction of Research coverage has a knock-on effect on liquidity, which is also an essential component of our capital markets ecosystem”); Merton, *supra* note 5 (finding that the loss of analyst coverage for a stock will reduce investor interest, with adverse effects on liquidity); see also The IPO Task Force, *Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth*, SEC (Oct. 20, 2011) (“IPO Task Force”), https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf (“Lack of research coverage adversely impacts trading volumes, company market capitalizations and the total mix of information available to market participants.”); Jeffrey M. Solomon, Cowen, Inc., *Capital Formation, Smaller Companies, and the Declining Number of Initial Public Offerings*, SEC, 14 (Jun. 22, 2017) (“Cowen Presentation”), <https://www.sec.gov/spotlight/investor-advisory-committee-2012/jeffrey-solomon-presentation.pdf> (“Little or no research coverage generally corresponds with lower stock liquidity.”).

presence.”³⁵ Other studies have found that one reason for this deterioration is that decreases in analyst coverage increases information asymmetry,³⁶ which can cause issuers to switch to financing that is less sensitive to information asymmetry, including decreasing their use of equity and long-term debt, or cause issuers to decrease their total investment (e.g., capital, research and development and acquisitions expenditures) and financing.³⁷ This decline in liquidity was shown in one study to be more significantly pronounced for smaller issuers, issuers with relatively less analyst coverage, and issuers with a bigger increase in information asymmetry resulting from the loss of an analyst.³⁸

In addition, studies have found that research coverage corresponds to liquidity by increasing investors’ recognition of issuers.³⁹ For example, one study found that market reactions to coverage changes are significantly correlated with the time and effort analysts devote to directing investors’ attention to issuers that they are covering, suggesting that coverage changes affect issuer value because they affect investors’ recognition.⁴⁰ Issuer visibility (e.g., news, extreme returns, initiations and drops of analyst coverage) has been shown to be a significant determinant of investors’ demand for analyst information.⁴¹ Having noticed

³⁵ Simona Mola et al., *Is There Life After the Complete Loss of Analyst Coverage?*, 88 ACCT. REV. 667, 670 (2013) (“Mola et al.”) (finding that “firms that lose all analyst coverage for one year are significantly more likely to delist than their covered peers”).

³⁶ See, e.g., Francois Derrien & Ambrus Kesckes, *The Real Effects of Financial Shocks: Evidence from Exogenous Changes in Analyst Coverage*, 89 ACCT. REV. 1407, 1408 (2013) (“Derrien & Kesckes”) (discussing empirical evidence finding that “a decrease in analyst coverage—through the resulting increase in information asymmetry and thus the cost of capital—causes a decrease in investment and financing”); Beyer et al., *supra* note 22, at 306-307 (“Economic theory suggests that voluntary disclosures and increased information quality reduce information asymmetries (either between the firm and market participants or between informed and uninformed investors.). This reduction in information asymmetries in turn increases the firm’s stock liquidity.”); see also 1972 Commission Statement, *supra* note 4, at 5290 (noting the important information sifting role of analysts).

³⁷ See Derrien & Kesckes, *supra* note 36, at 1409 (discussing how changes in analyst coverage cause changes in corporate policies).

³⁸ See *id.*

³⁹ See, e.g., Mola et al., *supra* note 35, at 670 (“[W]e find that the loss of analyst coverage reduces the number of investors who recognize and trade the firm’s stock, with attendant effects of widening the bid-ask spread and decreasing trading volume and institutional presence.”).

⁴⁰ Kevin K. Li & Haifeng You, *What is the Value of Sell-Side Analysts? Evidence from Coverage Initiations and Terminations*, 60 J. ACCT. & ECON. 141, 155 (2015) (finding that “analysts create value for the firms they cover through improving investor recognition, rather than reducing information asymmetry or improving fundamental performance”).

⁴¹ Lawrence et al., *supra* note 20, at 4 (“Media is a significant determinant of demand, supporting the inference that investors seek analyst guidance to provide resolution to news or possible uncertainty resulting in heightened visibility.”).

the importance of research to investors' recognition, certain issuers have endeavored to find non-traditional methods to direct investors' attention to their stocks, including by paying analyst firms to initiate coverage.⁴²

2. External Governance Mechanism

Studies have shown that monitoring and coverage of an issuer's management by research analysts can serve as a beneficial external governance mechanism.⁴³ Specifically, analysts' scrutiny increases corporate transparency, which may make it more difficult for corporate managers to engage in self-dealing activities such as asset transfers, excessive compensation and perquisite consumption.⁴⁴ Additionally, analysts can provide direct monitoring by, for example, tracking issuers' financial statements on a regular basis and directly interfacing with management by raising questions in earnings announcement conference calls.⁴⁵ Analysts can also provide indirect monitoring by, for example, distributing information to

⁴² See Autorité des Marchés Financiers ("AMF"), *The AMF Adopts its Action Plan to Promote Investment Research* (Jan. 27, 2020) ("AMF News Release"), <https://www.amf-france.org/en/news-publications/news-releases/amf-news-releases/amf-adopts-its-action-plan-promote-investment-research> (AMF, the securities market regulator in France, noting the trend of issuer-paid research); Tim Human, *AMF Pushes for New Charter on Issuer-Sponsored Research*, IR MAG. (Feb. 12, 2020) ("Human Article"), <https://www.irmagazine.com/small-cap/amf-pushes-new-charter-issuer-sponsored-research> (discussing AMF's action plan to promote investment research); *NIRI Guidelines Regarding Company-Sponsored Research*, NAT'L INV'R REL. INST. (Mar. 2020), <https://www.niri.org/NIRI/media/NIRI-Resources/NIRI-Company-Sponsored-Research-Guidelines-final.pdf> (providing guidelines to assist companies considering commissioning research from third-party firms); Mola et al., *supra* note 35 (discussing the value that issuers place on analyst coverage). In the absence of research coverage, issuers may seek to gain recognition through information sources that are outside traditional research sources (e.g., sources not provided by research analysts that are the focus of this Report), but may not be based on company fundamentals. For example, one study found that the attention generated through Twitter activity significantly impacts trading volume of small, volatile, and difficult-to-arbitrage stocks for which institutions are least likely to be actively invested. David Rakowski et al., *Twitter Activity, Investor Attention, and the Diffusion of Information*, 50 FIN. MGMT. 3, 34 (2021) ("Twitter activity is a unique and meaningful source of investor attention that has a statistically and economically significant association with trading volume and asset prices. This impact is best explained by the interpretation that Twitter increases investor attention and facilitates the diffusion of information among investors in ways that are not captured by traditional measures of attention.").

⁴³ See, e.g., Irani & Oesch, *supra* note 5, at 590 (noting the view that "analysts deter misreporting and discipline managerial misbehavior by serving as monitors alongside traditional mechanisms of corporate governance"); Tao Chen et al., *Do Analysts Matter for Governance? Evidence From Natural Experiments*, 115 J. FIN. ECON. 383 (2014) ("Chen et al.") (finding that "financial analysts play an important governance role in scrutinizing management behavior").

⁴⁴ Chen et al., *supra* note 43, at 385.

⁴⁵ *Id.* at 384-385.

investors through research reports and media outlets, thereby helping investors detect managerial misbehavior.⁴⁶

One study observed that after an issuer loses analyst coverage, markets factor in an increase in expected agency costs⁴⁷ by, for example, anticipating that with less analyst coverage, corporate managers are more likely to misuse their cash reserves.⁴⁸ This study also found that declines in the number of analysts covering an issuer (i.e., less scrutiny from analysts) increase chief executive officers' total and excess compensation⁴⁹ and the likelihood of issuers engaging in corporate acquisitions that destroy shareholders' wealth for private benefits.⁵⁰ Similarly, there is evidence that issuers increase their overall levels of earnings management⁵¹ when research coverage decreases because of decreased analysts' monitoring.⁵²

⁴⁶ *Id.* at 385.

⁴⁷ Broadly speaking, agency costs result when an agent fails to act in the best interests of his principal. *See, e.g.,* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309-10 (1976). Examples of agency costs in the corporate context (where the corporation is the principal and management is the agent) include corporate managers paying themselves extravagantly, working as little as possible, or even stealing from the company, all to the detriment of the corporation. Andrew A. Schwartz, *Mandatory Disclosure in Primary Markets*, 19 UTAH L. REV. 1069, 1071 (2019).

⁴⁸ Chen et al., *supra* note 43.

⁴⁹ "Excess compensation" has been defined as "compensation in excess of [the] equilibrium (economic) wage rate." John E. Core et al., *Corporate Governance, CEO Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 390 (1999).

⁵⁰ Chen et al., *supra* note 43, at 407 (finding that "with less monitoring from analysts, managers are more likely to extract private benefits at the expense of outside shareholders, indicating that analyst coverage plays an important role in protecting shareholder value by scrutinizing management behavior and reducing the costs for others to do so").

⁵¹ Earnings management occurs "when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers." Paul M. Healy & James M. Wahlen, *A Review of the Earnings Management Literature and its Implications for Standard Setting*, 13 ACCT. HORIZONS 365, 368 (1999). Earnings management is described by researchers to be either accrual-based or real activities-based. Accrual-based earnings management involves an issuer's managers making decisions concerning discretionary accruals to meet analyst targets. Real activities earnings management involves employing real operational activities to meet analyst targets. *See* John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3 (2005). Earnings management that is inconsistent with GAAP accounting may violate provisions of the federal securities laws. *See* Div. of Enf't, *2020 Annual Report*, SEC, 9-10 (2020), <https://www.sec.gov/files/enforcement-annual-report-2020.pdf> (describing matters alleging potential accounting and disclosure violations caused by, among other things, earnings management practices to mask unexpectedly weak performances).

⁵² Chen et al., *supra* note 43, at 405-06 (finding that when a firm experiences a decrease in analyst coverage, managers are more likely to engage in earnings management activities, which is "significantly more pronounced for firms with smaller initial analyst coverage"). While studies found that analyst coverage decreases result in increases in overall earnings management, one study found that issuers that lose analyst coverage are less likely to

Another study found that issuers that regained research coverage following a complete loss of coverage only decreased earnings management when they regained coverage by multiple analysts, suggesting the benefits of incremental analyst coverage for issuers that are already followed by at least one analyst.⁵³

III. Conflicts of Interest Related to Research

As beneficial as research can be for issuers and investors, the provision of research, particularly by sell-side analysts, may also raise investor protection and other concerns, notably the potential associated conflicts of interest. Business pressures on analyst firms, especially those with multiple lines of business such as full-service broker-dealers, create potential conflicts of interest that can reduce the objectivity of analysts' recommendations.⁵⁴ Highlighting the conflicts of interest applicable to sell-side analysts, IOSCO described these conflicts of interest as follows:

[A]nalysts . . . employed by full-service investment firms often face conflicts of interest that can interfere with the objectivity of their analysis. Conflicts arise because [analyst firms] often undertake many, potentially conflicting, roles – for example, firms may act as retail brokerage houses for individuals wishing to purchase or sell securities, while at the same time offering underwriting services to issuers of those securities – and research analysts are often called upon to assist with these conflicting activities. If an analyst's firm's activities place the analyst in conflict situations – for example, if the analyst has powerful

engage in real activities earnings management than firms with analyst coverage. The authors of this study suggested that managers may respond to analyst pressures by engaging in real activities manipulation through decreasing their expenditures by, for instance, disincentivizing innovative activity. Irani & Oesch, *supra* note 5, at 594.

⁵³ Laura Lindsey & Simona Mola, *Analyst Competition and Monitoring: Earnings Management in Neglected Firms* 2 (SEC, DERA Working Paper No. 2013-04, 2013), <https://www.sec.gov/files/rsfi-wp2013-04.pdf> (providing a disclaimer on the views expressed in staff working papers, which are “preliminary materials circulated to stimulate discussion and critical comment,” and finding, based on a sampling of firms that lost all research coverage and then regained coverage, that “dropped firms reverse their earnings management practice from significantly managing earnings downward to managing earnings upward”; and “[a]fter resumption of coverage, upward management is attenuated, but only for firms regaining coverage by multiple analysts”). See also Fang Yu, *Analyst Coverage and Earnings Management*, 88 J. FIN. ECON. 245, 268 (2008) (finding, based on a sampling of firms with and without research coverage, that “a higher level of analyst coverage is related to less earnings management and that change of analyst coverage is negatively related to change of earnings management”).

⁵⁴ See generally Analyzing Analyst Recommendations, *supra* note 19 (discussing factors that can create pressure on an analyst's independence and objectivity, including investment banking relationships, brokerage commissions, analysts' compensation and ownership interests in companies covered by an analyst); Fred Naffziger & Mark A. Fox, *Securities Analysts' Conflicts of Interest: Ethical and Legal Issues and International Regulatory Reactions*, 11 J. LEGAL STUD. IN BUS. 1 (2004) (providing an overview of analysts' conflicts of interest and legislative and regulatory measures addressing the conflicts).

financial incentives to direct clients towards specific securities, or if the analyst's job security depends on dissuading clients from selling certain shares – the advice the analyst offers may no longer be objective.⁵⁵

Specifically, increased or retention of investment banking business could benefit analysts to the extent that their compensation or position within a firm are tied to investment banking revenues and brokerage commissions.⁵⁶ Analysts may also have a conflict of interest if they own pre-IPO shares of the issuers that they cover or intend to purchase the shares before publishing their reports.⁵⁷ Moreover, analysts' objectivity may be compromised if their reports are reviewed and approved before publication.⁵⁸

Studies have identified a number of these conflicts of interest, with considerable evidence suggesting that some research may be tainted or biased. For instance, studies have found that analysts may issue overly optimistic stock research or favorable research in an effort to generate future investment banking business.⁵⁹ Similarly, studies have found that analysts

⁵⁵ IOSCO Report, *supra* note 30, at 2.

⁵⁶ See Armen Hovakimian & Ekkachai Saenyasiri, *Conflicts of Interest and Analyst Behavior: Evidence from Recent Changes in Regulation*, 66 FIN. ANALYST J. 96 (2010) (“Hovakimian & Saenyasiri”) (discussing studies documenting why analysts make overoptimistic earnings forecasts); Analyzing Analyst Recommendations, *supra* note 19 (“Brokerage firms’ compensation arrangements can put pressure on analysts to issue positive research reports and recommendations. For example, some firms link compensation and bonuses – directly or indirectly – to the number of investment banking deals the analyst lands or to the profitability of the firm’s investment banking division.”); The Fall of Enron: How Could It Happened?, Hearing before the S. Comm. on Governmental Aff., 107th Cong. 376 (2002) (statement of Arthur Levitt, Jr.) (“For years, we have known that analysts’ compensation is tied to their ability to bring in or support investment banking deals. . . . As long as analysts are paid based on banking deals that they generate or work on, there will always be a cloud over what they say.”). Analysts face these same pressures when making public appearances. See, e.g., Reg. AC Adopting Release, *supra* note 27.

⁵⁷ See Lori Richards, Director, SEC Off. of Compliance Inspections and Examinations, Analysts Conflicts of Interest: Taking Steps to Remove Bias (May 8, 2002) (“Richards Speech”), available at <https://www.sec.gov/news/speech/spch559.htm> (noting SEC exam staff’s finding that “if [a] company went public and the analyst’s firm underwrote the IPO, the analyst always issued positive research on the company”); see also IOSCO Report, *supra* note 30 (“Because research recommendations often have the ability to impact the price of a company’s securities, analysts may be inclined to produce favorable reports and recommendations in an attempt to maintain or boost the value of the securities held by the firm, or its clients. Similarly, a firm may take advantage of pending research and position themselves ahead of its publication, effectively ‘front-running’ their own recommendations.”).

⁵⁸ Richards Speech, *supra* note 57. See also Analyzing Analyst Recommendations, *supra* note 19 (discussing analysts’ potential conflicts of interest).

⁵⁹ See, e.g., Yuyan Guan et al., *Regulations and Brain Drain: Evidence from Wall Street Star Analysts’ Career Choices*, 65 MGMT. SCI. 5766 (2019) (“Guan et al.”) (“Sell-side analysts from investment banks have long been suspected of issuing overly optimistic stock research in exchange for investment banking business, especially during the Internet bubble period in the late 1990s”); Chih-Ying Chen & Peter F. Chen, *NASD Rule 2711 and Changes in Analysts’ Independence in Making Stock Recommendations*, 84 ACCT. REV. 1041, 1046 (2009) (“Chen

with investment banking ties to issuers that they cover tend to issue more favorable stock recommendations than analysts who do not have such ties; the affiliated analysts may also be reluctant to provide negative comments on issuers that they cover.⁶⁰ These studies found, in particular, that analysts affiliated with acquirers in merger and acquisition deals were more likely than unaffiliated analysts to upgrade their recommendation of the acquirers.⁶¹

Some broker-dealers' failure to manage analysts' conflicts of interest may have led to publications of tainted or biased research that contributed to the market exuberance of the late 1990s and subsequent declines during the early 2000s.⁶² Studies suggest that these incidents significantly eroded investor confidence in research, which, in turn, harmed the market for IPOs and capital formation.⁶³

& Chen") ("analysts may . . . have incentives to issue favorable research reports to induce future investment banking business").

⁶⁰ See Chen & Chen, *supra* note 59 (discussing studies finding analysts' conflicts of interest); Shane A. Corwin et al., *Investment Banking Relationships and Analyst Affiliation Bias: The Impact of the Global Settlement on Sanctioned and Non-sanctioned Banks*, 124 J. FIN. ECON. 614, 616 (2017) ("Corwin et al.") (citing studies showing that "affiliated analysts issue more optimistic recommendations, earnings forecasts, and long-term growth forecasts than unaffiliated analysts . . . and are slower to reveal negative news"); Hovakimian & Saenyasiri, *supra* note 56 (same); see also IOSCO Report, *supra* note 30 (discussing ways that analysts' conflicts can lead to false and misleading reports).

⁶¹ See Chen & Chen, *supra* note 59; Corwin et al., *supra* note 60.

⁶² See Federal Court Approves Global Research Analyst Settlement, SEC Litig. Rel. No. 18438 (Oct. 31, 2003) ("Global Settlement Release"), <https://www.sec.gov/litigation/litreleases/lr18438.htm>; NYSE/NASD IPO Advisory Comm., *Report and Recommendations of a Committee Convened by the New York Stock Exchange, Inc. and NASD at the Request of the U.S. Securities And Exchange Commission*, FINRA, 1-3 (2003) ("NYSE/NASD Report"), <http://www.finra.org/sites/default/files/Industry/p010373.pdf> (providing overview of market practices, including apparently biased recommendations by research analysts, during the stock market bubble of the late 1990s and early 2000s); Catalano, *supra* note 29, at 32 (discussing the wide belief that "compromised research by some investment banks contributed to the technology stock bubble of the late 1990s and its inevitable deflation beginning in 2001").

⁶³ See NYSE/NASD Report, *supra* note 62; see also Cowen Presentation, *supra* note 34, at 12 (showing the decrease in IPOs after 2000).

IV. Legislative and Regulatory Measures Addressing Conflicts and Their Impacts on Research Coverage

Multifaceted legislative, regulatory and other measures (collectively, “Measures”) have been taken that focused on the identification and management of conflicts of interest related to research.⁶⁴ The discussion that follows provides a brief overview of some of the notable features of the Measures that directly and uniquely govern the conduct of analysts, including sell-side analysts.⁶⁵

A. Legislative and Regulatory Measures Addressing Conflicts

1. Global Research Analyst Settlement

In 2003 and 2004, the SEC and other regulators brought enforcement actions, which were later settled, against twelve major investment banks (“Global Settlement Firms”)⁶⁶ for engaging in acts and practices that created or maintained inappropriate influence by investment banking over equity research analysts, thereby creating conflicts of interest on analysts that the firms failed to manage in an adequate or appropriate manner.⁶⁷ The settlement agreements that were reached in these enforcement actions, known as the Global Research Analyst Settlement (“Global Settlement”), included wide-ranging reforms that were designed to insulate sell-side

⁶⁴ See, e.g., The Impact of the Global Settlement, Hearing before the S. Comm. on Banking, Hous., and Urb. Aff., 108 Cong. 611 (2003) (statement of Sen. Richard Shelby) (discussing the effect of the Global Research Analyst Settlement on improving investor confidence); Reg. AC Adopting Release, *supra* note 27 (noting that the regulatory reforms were intended “to address conflicts of interest affecting the integrity and objectivity of research by securities firms”); FINRA, *Rules and Guidance: Research Analyst Rules* (“FINRA Guidance”), <https://www.finra.org/rules-guidance/key-topics/research-analyst-rules> (“The aim of FINRA’s [research rules] is to foster objectivity and transparency [. . .]”).

⁶⁵ The discussion that follows focuses on the Measures that the staff believes are most pertinent to Congress’s directive in Section 106 and the Measures applicable to sell-side research. See *infra* note 19 (discussing the Report’s focus on sell-side research). For example, this section of the report does not provide an overview of Regulation Fair Disclosure (17 C.F.R. § 243.100 *et seq.*) (“Reg. FD”) because Reg. FD governs the conduct of issuers and imposes certain disclosure requirements on issuers, not research analysts. Nor does this section cover Regulation Best Interest (17 C.F.R. § 240.151-1) (“Reg. BI”), which applies to broker-dealers’ recommendations to retail customers, and thus would not generally apply to broker-dealers’ recommendations to customers that are institutional money managers to advise their advisory clients. To the extent that a broker-dealer or its associated person (who could be a research analyst) makes a recommendation to an institutional customer, the recommendation would be subject to FINRA Rule 2111 (suitability), which is not covered in more detail in this section because it does not uniquely govern the conduct of analysts. For a more detailed overview of the legislative, regulatory and other measures pertaining to research, see Dana G. Fleischman, *TA Panel: Research Re-Imagined (CLE Outline)*, Securities Industry and Financial Markets Association (“SIFMA”), Compliance & Legal Society Annual Seminar (Mar. 17, 2020), <https://www.sifma.org/wp-content/uploads/2020/03/TA11-Research-Re-Imagined.pdf>.

⁶⁶ Due to acquisition of one Global Settlement Firm by another, eleven Global Settlement Firms remain.

⁶⁷ See Global Settlement Release, *supra* note 62.

analysts from investment banking pressure and make research more objective.⁶⁸ The original terms of the addendum to the Global Settlement set forth many undertakings. For example, the Global Settlement Firms were required to physically separate research and investment banking departments; prohibit analysts from participating in efforts to solicit investment business; create and enforce communications firewalls between analysts and investment bankers; not base analysts' compensation directly or indirectly on investment banking revenues or input from investment banking personnel; and, for a five-year period, contract with no fewer than three independent research firms at a time in order to make available independent research to the firms' customers.⁶⁹

The Global Settlement, which remains in place today, was modified in 2010, after the Global Settlement Firms asked a federal district court to repeal or alter certain specific provisions.⁷⁰ The court approved all of the Global Settlement Firms' requested changes, except the proposed modification to the firewalls provision, because the then-existing SRO research analyst rules⁷¹ addressed the same concerns as the Global Settlement and provided comparable protections.⁷²

2. Sarbanes-Oxley and FINRA Rule 2241

On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which contains a number of provisions regulating analysts' conflicts of interest. The provisions, codified in Section 15D of the Exchange Act,⁷³ direct the Commission, or upon authorization and direction of the Commission, a registered securities

⁶⁸ See *id.* The Global Settlement also included injunctive relief, monetary penalties and/or undertakings for the Global Settlement Firms and individual defendants. *Id.*

⁶⁹ Global Research Analyst Settlement Addendum A, SEC, Section I (Sept. 24, 2004) ("Global Settlement Addendum A"), available at <https://www.sec.gov/litigation/litreleases/finaljudgadda.pdf>.

⁷⁰ See Order Modifying Global Settlement, SEC (Mar. 15, 2010) ("Global Settlement Order"), available at <https://www.sec.gov/info/smallbus/acsec/acsec-020112-global-settlement.pdf>.

⁷¹ The then-existing SRO research analyst rules were replaced by FINRA Rule 2241. See *infra* note 77.

⁷² The court stated that approving the proposed modification to the firewalls provision "would be inconsistent with the Final Judgments and contrary to the public interest." Global Settlement Order, *supra* note 70, at 4-5. See also Gov't Accountability Off., *Securities Research: Additional Actions Could Improve Regulatory Oversight of Analyst Conflicts of Interest*, GAO 12-209, 11-12 (Jan. 12, 2012) ("GAO Report"), <http://www.gao.gov/products/GAO-12-209> (discussing the Global Settlement and the Global Settlement Firms' requested modifications).

⁷³ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501, 116 Stat. 745 (codified as amended at 15 U.S.C. § 78o-6).

association or national securities exchange, to adopt rules reasonably designed to address nine general topic areas relating to research analysts' conflicts of interest.⁷⁴

Specifically, the “analyst protections” portion of Sarbanes-Oxley addresses: (1) pre-approval of draft research reports by investment banking; (2) supervision and compensation of analysts; (3) retaliation against analysts; (4) quiet periods on the issuance of research reports; and (5) structural and institutional safeguards. The “disclosure” portion of Sarbanes-Oxley addresses: (1) disclosure of analysts' financial interests; (2) disclosure of firms' and analysts' compensation from an issuer; (3) disclosure of whether a subject company is a client of a firm; and (4) disclosure of analysts' compensation from their firms. Sarbanes-Oxley further directs the Commission or SROs to adopt any additional rules to address conflicts of interest and to require disclosures as the Commission or SROs deem appropriate.⁷⁵

Among other rules that the Commission and FINRA adopted to implement various requirements of Sarbanes-Oxley,⁷⁶ FINRA Rule 2241, in particular, is relevant to this Report because it directly and uniquely governs analysts' conduct.⁷⁷ Among other things, FINRA Rule 2241 mandates separation between research and investment banking, proscribes conduct that could compromise a research analyst's objectivity, and requires specific disclosures in research

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ FINRA, which is currently the only registered securities association, has adopted research analyst rules that implement provisions of Sarbanes-Oxley. See FINRA, *Research Analyst Rules*, <https://www.finra.org/rules-guidance/key-topics/research-analyst-rules#overview>. See also SEC, *SEC Implements Internal Control Provisions of Sarbanes-Oxley Act; Adopts Investment Company R&D Safe Harbor* (May 27, 2003), <https://www.sec.gov/news/press/2003-66.htm> (discussing Rule 3a-8 under the Investment Company Act of 1940 (“Investment Company Act”)); SEC, *Commission Approves Rules Implementing Provisions of Sarbanes-Oxley Act, Accelerating Periodic Filings, and Other Measures* (Aug. 27, 2002), <https://www.sec.gov/news/press/2002-128.htm> (discussing Rules 13a-14, 13a-15, 15d-14 and 15d-15 under the Exchange Act and Rule 30a-2 under the Investment Company Act).

⁷⁷ FINRA Rule 2241 was adopted in 2015 and replaced rules that were first adopted in 2002 and amended over the years: NASD Rule 2711 and NYSE Rule 472. See SEC, Order Approving a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Adopt FINRA Rule 2241 (Research Analysts and Research Reports) in the Consolidated FINRA Rulebook, Exch. Act Rel. No. 75471 (Jul. 16, 2015) (“Rule 2241 Order”), <https://www.sec.gov/rules/sro/finra/2015/34-75471.pdf>. See also SEC, Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 2241 (Research Analysts and Research Reports) in the Consolidated FINRA Rulebook, Exch. Act Rel. No. 73622 (Nov. 18, 2014), <https://www.sec.gov/rules/sro/finra/2014/34-73622.pdf>. FINRA stated in its 19b-4 filing that FINRA Rule 2241 “would retain the core provisions of [NASD Rule 2711 and NYSE Rule 472], broaden the obligations on members to identify and manage research-related conflicts of interest, restructure the rules to provide some flexibility in compliance without diminishing investor protection, extend protections where gaps have been identified, and provide clarity to the applicability of existing rules.” *Id.* at 6. FINRA also stated that, where consistent with protection of users of research, it believed that the proposed rule change reduces burdens on member firms where appropriate. *Id.*

reports and public appearances.⁷⁸ The rule also applies some requirements imposed by the Global Settlement more broadly to all FINRA members.⁷⁹

Specifically, FINRA Rule 2241 requires broker-dealers⁸⁰ to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to the preparation, content and distribution of research reports; public appearances by research analysts; and the interaction between research analysts and those outside of the research department. Such policies and procedures must “be reasonably designed to promote objective and reliable research that reflects the truly held opinions of research analysts and to prevent the use of research reports or research analysts to manipulate or condition the market or favor the interests of the member or a current or prospective customer or class of customers.”⁸¹ For example, such policies and procedures must restrict or limit research analysts’ activities that can reasonably be expected to compromise their objectivity, including prohibiting analysts from participating in pitches and other solicitations of investment banking services transactions; while analysts may attend pitch meetings in connection with an IPO offering of an EGC that is also attended by investment banking personnel, the analysts may not engage in otherwise prohibited conduct in the meetings, including efforts to solicit investment banking business.⁸² Such policies and procedures must also be reasonably designed to ensure that broker-dealers disclose, in any research report, an analyst’s financial interest in the issuer covered by the report.⁸³

⁷⁸ See FINRA, Regulatory Notice 17-14 (2017), <https://www.finra.org/rules-guidance/notices/17-14>.

⁷⁹ See *id.* (noting that “some provisions of the Global Settlement continue to apply only to members subject to the settlement (e.g., the Global Settlement requirements with respect to chaperoning communications between research and investment banking personnel are not incorporated into FINRA rules and apply only to Global Settlement firms”).

⁸⁰ FINRA Rule 2241 is applicable to all broker-dealers that are FINRA members, but broker-dealers with limited investment banking activity (as defined in FINRA Rule 2241) are exempt from certain provisions because the potential conflicts with investment banking are minimal. See Rule 2241 Order, *supra* note 77, at 22.

⁸¹ FINRA, Rule 2241(b)(2) (2015).

⁸² FINRA, Rule 2241(b)(2)(L)(i) (2015). Analysts employed by the Global Settlement Firms may not attend pitch meetings because such attendance is prohibited by the Global Settlement. See Global Settlement Addendum A, *supra* note 69, Section I.9 (prohibiting analysts from participating in pitch meetings). See also *infra* Section IV.A.4 (discussing provisions of the JOBS Act that prohibit the Commission or a registered national securities association from adopting or maintaining any rule or regulation in connection with an IPO restricting an analyst from participating in any communications with the management of an EGC that is also attended by any other associated person of a broker, dealer, or member of a registered national securities association whose functional role is other than as an analyst).

⁸³ See FINRA, Rule 2241(c)(4) (2015).

3. Regulation Analyst Certification

In 2003, the Commission adopted Regulation Analyst Certification (“Reg. AC”) to ensure that the views that analysts express in their reports accurately reflect their personal views “in order to promote the integrity of research reports and investor confidence in those reports.”⁸⁴ As the Commission stated in the adopting release, “Regulation AC is intended to complement other rules governing conflicts of interest disclosure by research analysts, including [SRO rules] and the anti-fraud provisions of the federal securities law.”⁸⁵

Reg. AC requires broker-dealers and certain persons associated with broker-dealers that publish, circulate or provide research reports to include in those reports a certification by a research analyst that (1) all of the views expressed in the report accurately reflect the analyst’s personal views about any and all of the subject securities or issuers; and (2) no part of the analyst’s compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the analyst in the report.⁸⁶ Alternatively, if part or all of the analyst’s compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the analyst in the report, the analyst’s certification must attest to this; identify the source, amount, and purpose of such compensation; and disclose that the compensation could influence the recommendations or views expressed in the report.⁸⁷ Reg. AC also requires quarterly certification by a research analyst regarding views expressed by the analyst in all public appearances during the prior quarter if a broker-dealer publishes, circulates, or provides a research report prepared by the analyst to a U.S. person in the United States.⁸⁸

4. JOBS Act

The Jumpstart Our Business Startups Act (“JOBS Act”)⁸⁹ was enacted in 2012 to, among other things, facilitate capital formation for EGCs by improving the availability and flow

⁸⁴ Reg. AC Adopting Release, 68 Fed. Reg. at 9482.

⁸⁵ *Id.* (noting that the Commission voted to propose Reg. AC before the passage of Sarbanes-Oxley, and citing to the related proposing release, Exch. Act Rel. No. 46301 (Aug. 2, 2002), 67 Fed. Reg. 51510 (Aug. 8, 2002), in which the Commission expressed that it would abide by Sarbanes-Oxley’s directives “as it continues to address analyst conflicts of interest issues”).

⁸⁶ 17 C.F.R. § 242.501.

⁸⁷ *Id.*

⁸⁸ 17 C.F.R. § 242.502 (“U.S. person” is defined in § 230.902(k), which includes, among other persons, “any natural person resident in the United States”).

⁸⁹ Pub. L. No. 112-106, 126 Stat. 306 (2012).

of research coverage of EGCs to investors. It contains two provisions concerning the publication of research reports about EGCs.⁹⁰ Both of these provisions prohibit the Commission or a registered national securities association (“RNSA”)⁹¹ from adopting or maintaining any rule or regulation that prohibits certain activities in connection with an IPO of the common equity of an EGC.⁹²

One of these provisions, Section 105(b), amends Section 15D of the Exchange Act to prohibit the Commission or an RNSA from adopting or maintaining any rule or regulation in connection with such an IPO: (1) restricting, based on functional role, which associated persons of a broker-dealer or RNSA member may arrange for communications between a securities analyst and a potential investor,⁹³ or (2) restricting a securities analyst from participating in any communications with the management of an EGC that is also attended by any other associated person of a broker-dealer or RNSA member whose functional role is other than as a securities analyst.⁹⁴ This provision was intended to allow analysts to participate in EGC management presentations with sales force personnel so that the management would not need to make

⁹⁰ Under the JOBS Act, an EGC is an issuer that had total annual gross revenues of less than \$1,070,000,000 during its most recently completed fiscal year. An issuer continues to be an EGC for the first five fiscal years after it completes an IPO, unless one of the following occurs: its total annual gross revenues are \$1.07 billion or more; it has issued more than \$1 billion in non-convertible debt in the past three years; or it becomes a “large accelerated filer,” as defined in Exchange Act Rule 12b-2. See 17 C.F.R. § 230.405.

⁹¹ “RNSA” is referenced in the Exchange Act as “national securities association” or “registered securities association.” Since FINRA is an RNSA, these provisions of the JOBS Act impact FINRA’s rules, including Rule 2241.

⁹² While the JOBS Act prohibits the Commission or an RNSA from adopting or maintaining the rules and regulations mentioned in this section, the Global Settlement Firms may not engage in activity that the JOBS Act allows if such activity is inconsistent with the terms of the Global Settlement because the JOBS Act did not alter the terms of the Global Settlement. See Div. of Trading & Mkts., *Jumpstart Our Business Startups Act Frequently Asked Questions About Research Analysts and Underwriters*, SEC (Aug. 22, 2012) (“JOBS Act FAQs”), <https://www.sec.gov/divisions/marketreg/tmjjobsact-researchanalystsfaq.htm> (“The JOBS Act does not amend or modify the Global Settlement.”). Additionally, certain FINRA’s rules, including Rule 2241, conform to the JOBS Act. See FINRA Guidance, *supra* note 64 (“FINRA’s equity research rules also conform to the JOBS Act”); FINRA, Regulatory Notice 15-30 at 7 (2015), https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-15-30.pdf (interpreting the joint due diligence provision of Rule 2241 to apply only to the extent it is not contrary to the JOBS Act).

⁹³ Exchange Act § 15D(c)(1), 15 U.S.C. § 78o-6(c)(1).

⁹⁴ Exchange Act § 15D(c)(2), 15 U.S.C. § 78o-6(c)(2). One example of such interactions is a pitch meeting. While this provision of the JOBS Act prohibits rules that restrict analyst attendance at such meetings, Commission staff has stated as follows: “Section 105(b) does not, however, permit analysts to engage in otherwise prohibited conduct in such meetings. Section 105(b) does not, for example, affect SRO rules that otherwise prohibit an analyst from engaging in efforts to solicit investment banking business.” See JOBS Act FAQs, *supra* note 92, Question 4.

separate and duplicative presentations to analysts at a time when senior management resources are limited.⁹⁵

The other provision, Section 105(d), amends Section 15D of the Exchange Act to prohibit the Commission or an RNSA from adopting or maintaining any rule or regulation that prohibits a broker-dealer or RNSA member from publishing or distributing research reports or making public appearances, with respect to the securities of an EGC, in two circumstances: (1) within any prescribed period of time following the EGC's IPO date,⁹⁶ or (2) within any prescribed period of time prior to the expiration date of any agreement between the broker-dealer or RNSA member and the EGC or its shareholders that restricts or prohibits the sale of securities held by the EGC or its shareholders after the IPO date.⁹⁷ This provision was intended to fully address the quiet periods imposed by the SRO rules on research relating to EGCs.⁹⁸

5. State Regulation of Analysts

Besides the Measures discussed above, analysts are subject to applicable state regulations. States may impose, for example, registration, licensing or qualification requirements on sell-side analysts that are broker-dealers and their agents.⁹⁹ The staff is not aware of any state regulations directly and uniquely governing the conduct of analysts that would impact the availability of research coverage for small issuers. However, state regulators

⁹⁵ See JOBS Act FAQs, *supra* note 92.

⁹⁶ JOBS Act § 105(d)(1).

⁹⁷ JOBS Act § 105(d)(2).

⁹⁸ See JOBS Act FAQs, *supra* note 92. FINRA subsequently amended NASD Rule 2711 to eliminate certain quiet periods with respect to an IPO of an EGC in order to conform to the JOBS Act requirements regarding quiet periods. See FINRA, Regulatory Notice 12-49 (2012), <https://www.finra.org/rules-guidance/notices/12-49>.

⁹⁹ See, e.g., Staff of the SEC, *Study on Investment Advisers and Broker-Dealers*, at 84-92 (Jan. 2011), <https://www.sec.gov/news/studies/2011/913studyfinal.pdf> (discussing state regulation of broker-dealers and noting that “many states require broker-dealers and their agents to observe high standards of commercial honor and just and equitable principles of trade in the conduct of business, and/or prohibit a variety of enumerated unethical or fraudulent practices”).

have brought a number of enforcement actions involving analysts' misconduct¹⁰⁰ – notably, actions in conjunction with the Global Settlement.¹⁰¹

B. Impacts of Measures on Research Coverage

The Measures address, among other things, the potential conflicts of interest related to research, with a view to improving the quality of research and restoring public confidence.¹⁰² In

¹⁰⁰ See, e.g., Citigroup Global Markets Inc., Docket No. 2012-0090 (Oct. 26, 2012), available at https://www.sec.state.ma.us/sct/archived/sctciti/Citi_Consent.pdf (consent order by The Commonwealth of Massachusetts (“Mass.”) finding that Citigroup violated, among other things, federal securities laws, and state securities laws prohibiting “unethical or dishonest conduct” and requiring reasonable supervision of its employees and SRO rules in connection with its analyst’s improper disclosure of research on Facebook IPO and information on other tech companies); Citigroup Global Markets Inc., Docket No. 2013-0014 (Oct. 2, 2013), available at <http://online.wsj.com/public/resources/documents/citiconsent1003.pdf> (consent order by Mass. finding that Citigroup violated, among other things, federal securities laws, state securities laws prohibiting “unethical or dishonest conduct,” a prior consent order and SRO rules in connection with its analyst’s disclosure of confidential, unpublished research views to certain clients); see also Morgan Stanley & Co. LLC, Docket No. 2012-0042 (Dec. 17, 2012), available at <https://www.sec.state.ma.us/sct/archived/sctms/Dkt-2012-0042-Consent-Order.pdf> (consent order by Mass. finding that Morgan Stanley violated, among other things, state securities laws prohibiting “unethical or dishonest conduct” and requiring reasonable supervision of its employees and a prior consent order in connection with the firm’s selective disclosure of confidential information about Facebook to analysts before its IPO). See generally Wall Street Analyst Conflicts of Interest Global Settlement, Hearing before the S. Comm. on Banking, Hous., and Urb. Aff. (2003) (testimony of Christine A. Bruenn, President, North American Securities Administrators Association, Inc. (“NASAA”)), available at <https://www.nasaa.org/882/wall-street-analyst-conflicts-of-interest-global-settlement/> (providing brief overview of state securities regulation and noting that “the states historically and in the current cases, investigate and bring enforcement actions – they do not engage in rulemaking for the national markets”).

¹⁰¹ See generally The Role of State Securities Regulators in Protecting Investors, Enforcement Overview, Hearing before the S. Comm. on Banking, Hous., and Urb. Aff. (2004) (testimony of Joseph P. Borg, Chairman of the Enft Sec., NASAA), available at <https://www.nasaa.org/872/the-role-of-state-securities-regulators-in-protecting-investors-enforcement-overview/> (discussing states’ role in the Global Research Analyst Settlement).

¹⁰² For example, evidence suggests that stock recommendations became less affected by conflicts of interest and more consistent with intrinsic value estimates based on analyst forecasts following certain regulatory reforms. See, e.g., Chen & Chen, *supra* note 59 (finding that the implementation of NASD Rule 2711, which prohibits NASD and NYSE members from tying analysts’ compensation to their company’s investment banking transactions and from offering favorable research or a specific rating or price target to a company as consideration or inducement for future business, enhanced analysts’ independence). Studies have also generally found that sell-side analysts’ stock recommendations became less optimistic after certain regulatory reforms, suggesting that the reforms may have helped address analysts’ conflicts. See, e.g., Guan et al., *supra* note 59 (stating that since the Global Settlement, “[s]ell-side analysts [were] more likely to issue neutral and pessimistic recommendations,” but “the overall informativeness of analyst recommendations has decreased”); GAO Report, *supra* note 72, at 11-12, 15 (finding that the Global Settlement and other regulatory actions were associated with improvements in analysts’ stock recommendations, but noting that “some studies arrived at different conclusions about the effectiveness of the regulatory reforms on factors other than analyst independence and objectivity”); Corwin et al., *supra* note 60, at 621 (finding that affiliated analysts’ bias was reduced by as much as 81% following the Global Settlement for analysts at sanctioned banks while analysts at non-sanctioned banks exhibited strong affiliation bias before and after the settlement). See also Analyzing Analyst Recommendations, *supra* note 19 (discussing the significance of some of the NYSE and FINRA rules aimed at increasing analysts’ independence and managing conflicts of interest).

addition to state enforcement actions, there have been a number of SEC and FINRA enforcement actions holding analysts accountable for their misconduct in this area.¹⁰³

There is evidence that some of these Measures – as well as other factors such as MiFID II¹⁰⁴ – may have impacted research coverage of small issuers,¹⁰⁵ but the extent of the Measures’ impact generally appears to be inconclusive, unclear, or difficult to isolate and individually measure.¹⁰⁶ Studies found that the number of analysts declined significantly in response to

¹⁰³ See, e.g., *FINRA Fines 10 Firms a Total of \$43.5 Million for Allowing Equity Research Analysts to Solicit Investment Banking Business and for Offering Favorable Research Coverage in Connection With Toys “R”Us IPO*, FINRA (Dec. 11, 2014), <https://www.finra.org/media-center/news-releases/2014/finra-fines-10-firms-total-435-million> (noting FINRA’s “commitment to policing the boundaries between research and investment banking to ensure that research is not improperly influenced”); Charles P. Grom, Exch. Act Rel. No. 77150 (Feb. 17, 2016) (finding that analyst violated Reg. AC by certifying research report’s recommendation that was inconsistent with his personal views); First Montauk Securities Corp. and Herbert Kurinsky, Exch. Act Rel. No. 57710A (Apr. 24, 2008) (finding that broker-dealer violated Reg. AC by distributing research report without its analyst’s certifications). *But see* GAO Report, *supra* note 72 (detailing FINRA and SEC enforcement actions involving analysts’ conflicts of interest and noting FINRA officials’ and SEC staff’s remarks that “the limited number of enforcement actions involving conflicts between equity research and investment banking suggests that the regulatory reforms have been effective”).

¹⁰⁴ See *infra* Section V.C (discussing impacts of MiFID II on payment mechanisms and research costs) and Section VI (discussing different theories about factors that impact research coverage of small issuers, such as a decline in the overall number of IPOs until 2020); see also Xiaohui Gao et al., *Where Have All the IPOs Gone?*, 48 J. FIN. & QUANTITATIVE ANALYSIS 6 (2013) (“Gao et al.”) (finding that “while [Sarbanes-Oxley] and the combined effects of decimalization and the Global Settlement on analyst coverage may have had some effect on small-company IPOs in the United States, the more fundamental problems are the absence of profitable small companies and the paucity of small companies that grow and become highly profitable, earning high returns for investors”); Craig Doidge et al., *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices Over Time* 42 (National Bureau of Economic Research, Working Paper No. 13079, 2007), available at https://www.nber.org/system/files/working_papers/w13079/w13079.pdf (finding that the characteristics of firms listing on U.S. exchanges have not significantly changed since the adoption of Sarbanes-Oxley and that “[i]f anything has changed in the aftermath of [Sarbanes-Oxley], it is that the non-listed firms have become smaller and are therefore less likely to list on the U.S. exchanges”).

¹⁰⁵ See, e.g., IPO Task Force, *supra* note 34, at 14 (“As a result [of the Global Settlement], most sell-side research analysts have shifted their attention to the high-volume, high-liquidity large-cap stocks that now drive revenues for their institutions and provide the basis for their compensation. This shift has resulted in less research coverage of emerging growth companies”); see also American Securities Association et al., *Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public* (Spring 2018), available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/IPO-Report_EXPANDING-THE-ON-RAMP.pdf (stating that “[b]y many measures, the JOBS Act has successfully breathed much-needed life into the IPO market” while acknowledging that “very few investment banks have published any pre-IPO research” and recommending ways to increase “[t]he amount of analyst research concerning small public companies[, which] has significantly declined in recent years for a host of reasons”).

¹⁰⁶ See Ehud Kamar et al., *Sarbanes-Oxley’s Effects on Small Firms: What is the Evidence?* (2007), available at https://scholarship.law.columbia.edu/cgi/viewcontent.cgi?article=2479&context=faculty_scholarship (finding that while there is evidence to support the proposition that Sarbanes-Oxley had a disproportionately negative impact on smaller issuers, the evidence is not conclusive, especially with regard to the long-term effects of the legislation); Hovakimian & Saenyasiri, *supra* note 56, at 105 (“Although disentangling the impact of the Global Settlement from that of related rules and regulations [(e.g., Reg. AC and SRO rules)] aimed at mitigating analysts’ conflicts of

some of the Measures and the remaining analysts focused on large issuers, leaving many small issuers without coverage.¹⁰⁷ As some studies explained, talented analysts left the sell-side research industry after the Measures led to a significant reduction in analysts' compensation and financial firms' research budgets, which, in turn, decreased the overall informational benefit of research.¹⁰⁸ Additionally, reforms to separate research from investment banking may have "prevented issuers from taking full advantage of their underwriters' expertise in [IPOs] and diminished the important role research analysts traditionally have played in the IPO underwriting process."¹⁰⁹ However, as one study indicated, there was a decline in analysts and research coverage of small issuers well before the Measures, but this study did not address the reasons for the decline or whether there was any one factor contributing to that decline.¹¹⁰ Moreover, another study found, in the context of MiFID II, that analysts who produced low-quality research, in terms of forecast accuracy, were more likely to leave the research industry and the remaining analysts produced better research.¹¹¹

interest is impossible, forecast bias clearly declined around the time the Global Settlement was announced. These results suggest that the recent efforts of regulators have helped neutralize analysts' conflicts of interest.").

¹⁰⁷ See, e.g., IPO Task Force, *supra* note 34, at 26 (noting the dramatic decline of research coverage before 2011 was due to economic and regulatory pressures that reduced research budgets); Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA Law Review 39 (2007) ("Fisch") (finding that the regulatory reforms addressing analysts' conflicts of interest eliminated investment banking revenues as a source of funding research, resulting in dramatic reduction of research coverage of small issuers).

¹⁰⁸ See Fisch, *supra* note 107, at 75 (noting that financial firms' reduction of analysts' compensation was a natural response to the inability of analysts to participate in investment banking); see also Guan et al., *supra* note 59 (concluding that the restrictions imposed by the reforms led to a significant reduction in sell-side analysts' bonuses and total compensation and their departure may have led to a decrease in the overall informativeness of analysts' recommendations). But see Garnet Roach, *European Small-Cap Coverage Increases Since Mifid II*, IR MAG., Feb. 10, 2021, <https://www.irmagazine.com/small-cap/european-small-cap-coverage-increases-mifid-ii> (citing a report showing, based on a survey of more than 900 corporate investor relations professionals, that research coverage of EU small-cap issuers has increased since MiFID, after a reduction in coverage globally of issuers of all cap sizes in 2019 and 2020).

¹⁰⁹ Catalano, *supra* note 29, at 32 ("The consequences for issuers and investors are manifest in IPO pricing inefficiency and in research by underwriters that often conflicts with their recommendations to buy the stock on the offering."). See also Cowen Presentation, *supra* note 34.

¹¹⁰ See U.S. Gov't Accountability Off., *Report to the Committee on Small Business and Entrepreneurship, U.S. Senate* 24, n.25 (Apr. 2006), <https://www.gao.gov/assets/gao-06-361.pdf> ("Well before the passage of the Sarbanes-Oxley Act, analysts noted . . . a decline in analyst and research coverage of smaller companies . . .").

¹¹¹ Yifeng Guo & Lira Mota, *Should Information be Sold Separately? Evidence from MiFID II*, 142 J. FIN. ECON. 97, 99 (2021) ("Guo & Mota") (finding that after MiFID II, "analysts who produce worse research are more likely to leave the market" and "analysts who remain in the research market produce better research"). For further discussion of analysts' behavior and research coverage in the post-IPO context, see Daniel J. Bradley et al., *Analyst Behavior Following IPOs: The "Bubble Period" Evidence*, 21 Rev. of Fin. Studies 1 (2008) (finding, based on analysts' recommendations following IPOs from 1999 to 2000, that "there is no reliable relation between the number of managing underwriters and the number of brokers who follow a firm by the end of its first anniversary

V. Payment Mechanisms and Costs of Research

Money managers may use various mechanisms to pay for sell-side and independent research. In the United States, research provided by broker-dealers typically has not been “priced” separately from other broker-dealer services.

Specifically, as discussed in more detail below, many money managers have historically used client assets to pay for brokerage and research services through bundled commission payments, commonly known as “soft dollars,” pursuant to a safe harbor provided by Section 28(e) of the Exchange Act, which allows a money manager to pay a negotiated, variable commission rate in which order execution is bundled along with “brokerage and research services,” if the manager determines in good faith that the amount of the commission paid is reasonable in relation to the value of the brokerage and research services received.¹¹² In addition to soft dollars, money managers in the United States may use “hard dollars” to pay for sell-side and independent research by making direct payments from their own resources.¹¹³

An EU law known as MiFID II, which went into effect in 2018, has influenced the use of these payment mechanisms in the United States.¹¹⁴ Specifically, in an effort to address potential conflicts of interest associated with money managers purchasing research, MiFID II permits money managers to use hard dollars or funds from a separate research payment account (“RPA”) to pay for research; MiFID II has, in effect, banned money managers subject to the legislation from using bundled commission payments to pay for research with respect to their EU clients.¹¹⁵ This led to an increasing number of U.S. money managers to ask U.S. broker-dealers if they would accept hard dollars for their research. Some broker-dealers have been reluctant to accept hard dollars for their research,¹¹⁶ expressing concerns that accepting hard dollars for research could subject the broker-dealers to regulation and registration under the

as a publicly traded company,” and suggesting that “firms going public may be under the illusion that they are paying for research at the time of the IPO, but within a very short period of time other factors are the more important determinants of analyst coverage”).

¹¹² 15 U.S.C. § 78bb(e).

¹¹³ As discussed below, money managers can rely on the Section 28(e) safe harbor to use client assets to pay for research; additionally, some U.S. broker-dealers have refused to accept hard dollars for their research because it raises questions regarding their status as an “investment adviser” under the Advisers Act.

¹¹⁴ See Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast), O.J. (L 173) 349 (Dec. 6, 2014) (“MiFID II”), available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065>.

¹¹⁵ See also *infra* notes 151 and 152 and corresponding text discussing amendments to MiFID II.

¹¹⁶ See *infra* note 144.

Advisers Act. In particular, a broker-dealer is excluded from the definition of “investment adviser” under the Advisers Act so long as its provision of investment advice is “solely incidental” to the conduct of its business as a broker-dealer and it receives no “special compensation” for the advice.¹¹⁷ Some broker-dealers have registered as investment advisers, enabling them to accept hard dollars for research.¹¹⁸

Although the staff does not have access to data to ascertain the costs of research paid for through soft dollars or hard dollars,¹¹⁹ studies have found that MiFID II has had impacts on research beyond the EU. In particular, as discussed below, studies have found that MiFID II has impacted the payment mechanisms for research and research costs for money managers and research providers subject to U.S. law.

A. Brokerage Commissions or “Soft Dollars” for Research

In 1972, the Commission released a policy statement about the U.S. securities markets “and the direction in which the public interest requires that they evolve.”¹²⁰ The Commission acknowledged that it was a “fundamental element of the brokerage function” for broker-dealers to provide research, and expressed the view that it was appropriate for broker-dealers to be compensated for the research through their receipt of commission payments.¹²¹

¹¹⁷ See Section 202(a)(11) of the Advisers Act, 15 U.S.C. § 80b-2(a)(11).

¹¹⁸ See Michael Mayhew, Integrity Research Associates, *Can Asset Managers Not Subject to MiFID II Use Cash to Pay for US Research?*, Jan. 27, 2020, <https://www.integrity-research.com/can-asset-managers-not-subject-mifid-ii-use-cash-pay-us-research/> (“At least five US brokers including Bank of America Merrill Lynch, Deutsche Bank, Jefferies, Nomura Securities and BMO Capital Markets previously decided to register their research departments as investment advisers to enable any asset manager to use cash to pay for their investment research.”); see also Peter Smith & Robin Wigglesworth, *BofA Breaks Ranks to Take Investment Adviser Status Ahead of Mifid*, FIN. TIMES, Oct. 24, 2017, <https://www.ft.com/content/b840973e-b803-11e7-8c12-5661783e5589> (“BofA’s decision to make its research unit a registered investment adviser allows the bank to accept hard dollars for US research services from any investor in the world.”); Laura J. Keller, *BofA Inches Closer to U.S. Research Fees as MiFID Looms*, BLOOMBERG, Nov. 5, 2017, <https://www.bloombergquint.com/markets/bofa-makes-legal-move-to-charge-for-u-s-research-as-mifid-looms> (observing that Deutsche Bank AG’s investment bank included its research services in its investment adviser registration, but indicated in its SEC filing that its research is provided through its broker-dealer status, not as an investment adviser).

¹¹⁹ Cf. Howell E. Jackson & Jeffrey Y. Zhang, *The Economics of Soft Dollars: A Review of the Literature and New Evidence from the Implementation of MiFID II* 19 (2020) (“Jackson & Zhang”), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3673470 (noting that “researchers do not have a good line of sight into the amount of research funded with soft dollars at the fund level either at the individual fund level or in the aggregate”).

¹²⁰ 1972 Commission Statement, *supra* note 4.

¹²¹ *Id.* at 5290.

In the United States, institutional money managers historically used brokerage commissions to pay broker-dealers for sell-side research along with order execution.¹²² Up until 1975, brokerage commission rates were fixed, and broker-dealers competed for institutional business on the basis of providing services, including non-execution services such as research reports.¹²³ As the end of the fixed-rate era drew near in the early 1970s, institutional money managers and broker-dealers questioned how competition over commission rates would disrupt these practices.¹²⁴ Fiduciary principles require money managers to seek best execution for client trades and limit money managers from using client assets for their own benefit.¹²⁵ Money managers expressed concern that in an environment of competitive commission rates, they would be forced to allocate brokerage solely on the basis of lowest execution costs, or that paying more than the lowest commission rate would be deemed a breach of fiduciary duty, and that useful research might become more difficult to obtain.¹²⁶ Broker-dealers expressed concern that they could no longer be compensated in commissions for their work product if orders were routed to broker-dealers that provided execution-only service at lower rates.¹²⁷

Congress addressed these concerns by enacting Section 28(e) of the Exchange Act to allow money managers to use client funds to purchase “brokerage and research services” for their managed accounts under certain circumstances without breaching their fiduciary duties to clients.¹²⁸ Following the enactment of Section 28(e), money managers used – and continue to use – client funds to pay brokerage commissions for both order execution and other “brokerage and research services” that inure to the benefit of advisory clients.

In the years since Congress enacted Section 28(e), the Commission has issued interpretations and guidance on the application of the safe harbor to money managers’ acquisition of research for the benefit of their advised accounts.¹²⁹ In its most recent

¹²² See generally 2006 Release, *supra* note 30.

¹²³ *Id.* at 41980.

¹²⁴ *Id.*

¹²⁵ *Id.* at 41978. See also Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Rel. No. 5248 (Jun. 5, 2019), 84 Fed. Reg. 33669, 33675 (Jul. 12, 2019).

¹²⁶ 2006 Release, 71 Fed. Reg. at 41980.

¹²⁷ *Id.*

¹²⁸ 15 U.S.C. § 78bb(e). Section 28(e) provides a safe harbor that protects money managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate in order to receive “brokerage and research services” provided by a broker-dealer, if the managers determine in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services received. 2006 Release, 71 Fed. Reg. at 41978.

¹²⁹ See 2006 Release, *supra* note 30; Commission Guidance on the Scope of Section 28(e) of the Exchange Act, Exch. Act Rel. No. 45194 (Dec. 27, 2001), 67 Fed. Reg. 6 (Jan. 2, 2002); 1986 Release, *supra* note 30; Report of Investigation in the Matter of Investment Information, Inc. Relating to the Activities of Certain Investment Advisers, Banks, and Broker-Dealers, Exch. Act Rel. No. 16679, 19 SEC Docket 926 (Mar. 19, 1980); Use of

interpretation in 2006, the Commission interpreted the scope of the safe harbor based upon changing market conditions, industry practices, and the purposes underlying Section 28(e).¹³⁰ The Commission highlighted the importance of money managers' access to greater breadth and depth of research by stating that the Section 28(e) safe harbor "encompasses third-party research and proprietary research on equal terms."¹³¹ The Commission interpreted the safe harbor to "permit the industry to flexibly structure arrangements that are consistent with the statute and best serve investors," in particular, through CCAs.¹³²

The Commission's 2006 interpretation stated that Section 28(e) applies to arrangements involving "commissions paid to full service broker-dealers that provide brokerage and research services directly to money managers, and to third-party research arrangements where the research services and products are developed by third parties and provided by a broker-dealer that participates in effecting the transaction."¹³³ The 2006 Release observed that the industry had developed CCAs that allowed money managers to have their trades executed by one broker-dealer and obtain research and other services from another broker-dealer.¹³⁴ In some of these arrangements, the introducing broker-dealer accepts orders from money managers (submitting orders for their advised accounts) and then executes the trade and provides research, while a second broker-dealer clears and settles the transaction.¹³⁵ In other arrangements, an introducing broker-dealer facilitates access to research, but has little, if any, role in accepting orders or in executing, clearing, or settling any portion of the trade.¹³⁶ The Commission expressed the view

Commission Payments by Fiduciaries, Exch. Act Rel. No. 12251 (Mar. 24, 1976), 41 Fed. Reg. 13678 (Mar. 31, 1976) ("1976 Release").

¹³⁰ See 2006 Release, 71 Fed. Reg. at 41979.

¹³¹ *Id.* at 41992 (stating that "several commenters expressly endorsed the Commission's view that independent research providers should be accorded equal treatment with proprietary research providers" and "[n]one of the commenters disputed this point," but acknowledging commenters with differing views on other issues related to the Section 28(e) safe harbor). In the 1976 Release and 1986 Release, the Commission indicated that "under appropriate circumstances," money managers may use client commissions to obtain third-party research (i.e., research produced by someone other than the executing broker-dealer). 1986 Release, 51 Fed. Reg. at 16007; 1976 Release, 41 Fed. Reg. at 13679. Section 28(e) requires that research be "provided by" the broker-dealer that is "effecting" the transactions, which up until the Commission's interpretation in the 2006 Release, limited the circumstances in which money managers could obtain third-party research. In the 2006 Release, the Commission modified its interpretation of "provided by" and "effecting" under Section 28(e) to clarify money managers' ability to access third-party research. 2006 Release, 71 Fed. Reg. at 41993-95.

¹³² 2006 Release, 71 Fed. Reg. at 41992.

¹³³ *Id.* at 41983-41984.

¹³⁴ *Id.* at 41993.

¹³⁵ *Id.*

¹³⁶ *Id.* In a typical CCA, a money manager places a client order through an executing broker-dealer and pays a single "bundled" commission for order execution and Section 28(e)-eligible brokerage and research services. The executing broker-dealer credits the portion of the commission for research to a CCA administered by the executing broker-dealer and retains the remainder of the commission payment. Alternatively, the executing broker-dealer

that this separation of functions is beneficial to the money managers' clients when an efficient execution venue provides good, low-cost execution while a research venue contributes research that is beneficial to managed accounts.¹³⁷

B. "Hard Dollars" for Research

Bundled commission payments made under Section 28(e) (or "soft dollars") are distinguishable from payments for research with "hard dollars," which are payments in cash and may include direct payments from a money manager's own resources rather than from client assets. U.S. money managers may typically pay for research with soft dollars under Section 28(e) rather than hard dollars. Before MiFID II was implemented in January 2018, EU money managers were similarly permitted to use bundled commission payments rather than hard dollars to pay for research.

Broadly speaking, the EU adopted MiFID II to "strengthen investor protection and improve the functioning of financial markets making them more efficient, resilient and transparent."¹³⁸ As discussed below, MiFID II requires money managers to "unbundle" research payments from execution payments.¹³⁹ This requirement was intended to address the potential conflicts of interest associated with money managers tying research-buying decisions with execution decisions and to increase transparency of the costs of research and execution for investors.¹⁴⁰

may forward the research portion of the commission to a CCA administered by an external aggregator or administrator. The money manager then receives research from a third-party research provider or the executing broker-dealer, paid for by the CCA assets. Where an external aggregator or administrator is used, the money manager instructs the executing broker-dealer to deduct the portion of the commission payment for brokerage, including execution, from payments going to the CCA administered by that third party. *See, e.g.*, Letter from Securities Industry and Financial Markets Association's Asset Management Group ("SIFMA AMG") to Heather Seidel, Acting Director, SEC Div. of Trading & Mkts. (Oct. 25, 2017), *available at* <https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf> (describing a typical CCA in a request for a no-action letter).

¹³⁷ 2006 Release, 71 Fed. Reg. at 41993.

¹³⁸ European Securities and Markets Authority ("ESMA"), *MiFID II*, <https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir>. MiFID II sought to achieve a variety of regulatory goals. ESMA, the EU's securities markets regulator, observed that, through MiFID II, "[t]he protection of investors is strengthened through the introduction of new requirements on product governance and independent investment advice, the extension of existing rules to structured deposits, and the improvement of requirements in several areas, including on the responsibility of management bodies, inducements, information and reporting to clients, cross-selling, remuneration of staff, and best execution." *Id.*

¹³⁹ MiFID II, *supra* note 114.

¹⁴⁰ *See* Commission Delegated Directive (EU) 2017/593 of 7 April 2016, supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits, art. 13(9), O.J. (L 87) 500 (Mar. 31, 2017) ("EU Delegated Directive"), *available at* <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L0593&from=EN> (stating that MiFID II restricted the possibility for

In effect, MiFID II bans certain inducements (such as fees, bundled commissions, and non-monetary benefits) that investment firms pay or receive in connection with their provision of services to clients; these inducements are permitted only to the extent that they are designed to enhance the quality of service to clients.¹⁴¹ It is not considered to be an inducement under MiFID II if the investment firm receives research in return for: (1) direct payments from the investment firm’s own resources; and/or (2) payments from a separate RPA that is controlled by the investment firm and funded with client assets, provided that certain conditions are met.¹⁴² The consequence of this ban is that money managers subject to MiFID II must, in effect, “unbundle commissions” by making payments for execution separately from payments for research.¹⁴³ Accordingly, while money managers subject to U.S. law may continue to make bundled commission payments to broker-dealers for brokerage and research services under Section 28(e) of the Exchange Act, money managers that are subject to MiFID II may no longer make those bundled payments.

The EU’s unbundling requirement led some U.S. money managers to ask certain U.S. broker-dealers if they would accept “hard dollars” for their research.¹⁴⁴ Some U.S. broker-dealers have been reluctant to accept hard dollar payments, expressing concerns about their

firms to receive or pay inducements to “increase clarity to clients as to the quality of services they receive” and that the supply of and charges for execution services “shall not be influenced or conditioned by levels of payment for execution services”); *see also* MiFID II, *supra* note 114 (“The expanding range of activities that many investment firms undertake simultaneously has increased potential for conflicts of interest between those different activities and the interests of their clients. It is therefore necessary to provide for rules to ensure that such conflicts do not adversely affect the interests of their clients.”). Section 28(e) addresses a money manager’s conflicts by allowing the money manager to pay higher commissions than are otherwise available to obtain brokerage and research services on behalf of a client if the money manager makes a good faith determination that the amount of commissions paid is reasonable. *See* 2006 Release, 71 Fed. Reg. at 41980.

¹⁴¹ MiFID II, *supra* note 114.

¹⁴² EU Delegated Directive, *supra* note 140. Payments may be made from a separate RPA under the control of the investment firm, provided that the following conditions relating to the operation of the account are met: “(i) the research payment account is funded by a specific research charge to the client; (ii) as part of establishing a research payment account and agreeing [to] the research charge with their clients, investment firms set and regularly assess a research budget as an internal administrative measure; (iii) the investment firm is held responsible for the research payment account; [and] (iv) the investment firm regularly assesses the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions.” *Id.*

¹⁴³ *Id.*

¹⁴⁴ This question has been raised on behalf of U.S. money managers with a global business as well as EU money managers that frequently purchase research from U.S. broker-dealers. *See, e.g.*, Letter from American Securities Association to SEC Chairman Jay Clayton (May 2, 2019) (“American Securities Letter”); Letter from Sidley Austin LLP to SEC Chairman Walter Jay Clayton (Mar. 19, 2019) (“Sidley Austin Letter”); Letter from The Capital Group Companies, Inc. to SEC Chairman Walter Jay Clayton (Feb. 11, 2019) (“Capital Group Letter”); Letter from MFS Investment Management to SEC Chairman Walter Jay Clayton (Oct. 16, 2018), each *available at* <https://www.sec.gov/comments/mifidii/mifidii.htm>.

resulting status under the Advisers Act.¹⁴⁵ In particular, a broker-dealer is excluded from the definition of “investment adviser” under the Advisers Act so long as its provision of investment advice is “solely incidental” to the conduct of its business as a broker-dealer and it receives no “special compensation” for the advice.¹⁴⁶ As a general matter, U.S. broker-dealers expressed concern that if they received “hard dollars” for their research, those fees could subject the broker-dealer to regulation under the Advisers Act.¹⁴⁷ In turn, U.S. money managers raised concerns that if a U.S. broker-dealer is unwilling or unable to accept separate payments for research (i.e., payments that are not bundled with commission payments for order execution), money managers may not be able to obtain necessary research that would benefit their advised accounts.¹⁴⁸

In 2017, the Commission’s Division of Investment Management took a temporary no-action position stating that the staff would not recommend enforcement action if broker-dealers receive research payments in “hard dollars” from money managers who are subject to MiFID II without the broker-dealers being considered investment advisers; the temporary position was intended to provide the staff and market participants with time to better understand the evolution of business practices after the implementation of MiFID II and, following the extension, to continue to monitor developments in Europe that could affect business practices.¹⁴⁹ At the same time, the Commission’s Division of Trading and Markets issued a no-

¹⁴⁵ See American Securities Letter, *supra* note 144; Sidley Austin Letter, *supra* note 144; Capital Group Letter, *supra* note 144.

¹⁴⁶ See Section 202(a)(11) of the Advisers Act, 15 U.S.C. § 80b-2(a)(11). The Commission provided an updated interpretation on when the provision of advice falls within the “solely incidental” prong of the broker-dealer exclusion. See Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Advisers Act Rel. No. 5249 (Jun. 5, 2019), 84 Fed. Reg. 33681 (Jul. 12, 2019).

¹⁴⁷ See, e.g., Letter from SIFMA to Douglas J. Scheidt, Associate Director, SEC Div. of Investment Mgmt. (Oct. 17, 2017), available at <https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a-incoming.pdf> (requesting no-action letter).

¹⁴⁸ See, e.g., Letter from SIFMA AMG to SEC Chairman Walter Jay Clayton (Dec. 14, 2018), available at <https://www.sec.gov/comments/mifidii/cll5-4881876-177433.pdf>. Other commenters also addressed measures to facilitate cross-border implementation of MiFID II’s research provisions. See, e.g., Letter from Healthy Markets Association et al. to SEC Chairman Jay Clayton (Jun. 26, 2019) (recommending revising guidance under Section 28(e) of the Exchange Act to impose additional requirements on money managers to enhance transparency on research costs and the use of client commissions to pay for it); Letter from Nucleus195 to SEC Chairman Jay Clayton (Mar. 11, 2019) (supporting unbundled model, with broker-dealers being paid directly for their research); and Letter from Council of Institutional Investors to SEC Chairman Jay Clayton (Jan. 31, 2019) (“While we understand concerns that the unbundling of broker-dealer commissions might adversely affect research availability for the smallest public companies, we have yet to see compelling evidence of that effect.”) (footnote omitted), each available at <https://www.sec.gov/comments/mifidii/mifidii.htm>.

¹⁴⁹ SIFMA, SEC Staff No-Action Letter (Oct. 26, 2017), available at <https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm>. The temporary no-action position was originally for 30 months, until July 2020. In November 2019, the Division of Investment Management extended the position to July 3, 2023. See SIFMA, SEC Staff No-Action Letter (Nov. 4, 2019), available at <https://www.sec.gov/investment/SIFMA-110419>. The Division of Investment Management issued an additional no-action letter to provide a staff position related to MiFID II’s unbundling requirements. See

action letter stating that the staff would not recommend enforcement action if, under certain circumstances, money managers pay for research through the use of an RPA in reliance on the Section 28(e) safe harbor.¹⁵⁰

Subsequently, in February 2021, as part of the European Commission’s overall coronavirus recovery strategy aimed at making it easier for the capital markets to support the recovery of European businesses, the European Commission (“EC”) adopted amendments to MiFID II that would permit bundled commission payments for research on small- and mid-cap issuers, with the goal of incentivizing the provision of research with respect to those issuers.¹⁵¹ The UK securities market regulator, the Financial Conduct Authority (“FCA”), issued, in April 2021, a consultation paper on capital markets reform that involved looking at changes to the UK’s implementation of MiFID II,¹⁵² and, in November 2021, a policy statement summarizing the feedback that it received on the consultation paper and outlining its final policy position and rules.¹⁵³

Investment Company Institute, SEC Staff No-Action Letter (Oct. 26, 2017), *available at* <https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm> (stating that the staff would not recommend enforcement action if investment advisers continue to aggregate client orders for purchases and sales of securities, where some clients may pay different amounts for research because of MiFID II requirements, but all clients will continue to receive the same average price for the security and execution costs).

¹⁵⁰ SIFMA AMG, SEC Staff No-Action Letter (Oct. 26, 2017), *available at* <https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf>. The letter specified four circumstances in which the no-action position would apply: (1) the money manager makes payments to the executing broker-dealer out of client assets for research alongside payments to that executing broker-dealer for execution; (2) the research payments are for research services that are eligible for the safe harbor under Section 28(e); (3) the executing broker-dealer effects the securities transaction for purposes of Section 28(e); and (4) the executing broker-dealer is legally obligated by contract with the money manager to pay for research through the use of an RPA in connection with a CCA.

¹⁵¹ Directive (EU) 2021/338 of the European Parliament and of the Council of 16 February 2021 amending Directive 2014/65/EU as regards information requirements, product governance and position limits, and Directives 2013/36/EU and (EU) 2019/878 as regards their application to investment firms, to help the recovery from the COVID-19 crisis, O.J. (L 68) (Feb. 26, 2021) (“EU Amendment”), *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L_.2021.068.01.0014.01.ENG&toc=OJ%3AL%3A2021%3A068%3ATOC (“Research on small and middle-capitalisation issuers is essential to help issuers to connect with investors. That research increases the visibility of issuers and thus ensures a sufficient level of investment and liquidity. Investment firms should be allowed to pay jointly for the provision of research and for the provision of execution services provided certain conditions are met. One of the conditions should be that the research is provided on issuers whose market capitalisation did not exceed EUR 1 billion, as expressed by the end-year quotes, for the 36 months preceding the provision of the research.”).

¹⁵² FCA, CP21/9: Changes to UK MiFID’s Conduct and Organisational Requirements (Apr. 28, 2021) (“FCA Consultation Paper”), *available at* <https://www.fca.org.uk/publication/consultation/cp21-9.pdf> (proposing exemptions from MiFID II’s inducement rules for research on small and medium-sized enterprises (“SMEs”) that have market capitalization below £200m and for fixed income, currencies and commodities research).

¹⁵³ FCA, PS21/20: Changes to UK MiFID’s Conduct and Organisational Requirements (Nov. 2021) (“FCA Policy Statement”), *available at* <https://www.fca.org.uk/publication/policy/ps21-20.pdf> (adopting new inducement rules relating to research, including the exemptions proposed in the FCA Consultation Paper and modified exemptions).

Studies have found that MiFID II has had consequences beyond the EU, notably its impacts on payment mechanisms and research costs for money managers and research providers subject to U.S. law.

C. Impacts of MiFID II on Payment Mechanisms and Research Costs

Numerous studies have analyzed the impacts of MiFID II on research, some of which cover different payment mechanisms for research and costs of research, but not necessarily in the context of small issuers specifically.¹⁵⁴ Although many of the studies were focused on European market participants, these studies are worth noting because, as discussed above, to the extent that market participants have global operations, they may change their practices in response to MiFID II on a global scale.¹⁵⁵ One academic study noted the data limitations of these studies, indicating that as of October 2020, none of the industry reports or academic articles regarding the impact of MiFID II on market performance and analyst coverage utilized data from 2020 and that empirical analyses all stopped in 2019.¹⁵⁶ While the results from these studies vary and may even be contradictory on the issues of availability and coverage of research,¹⁵⁷ there appears to be a general consensus on several key points relating to payment mechanisms for research and research costs.

As discussed below, studies have found that, after MiFID II was implemented, both asset managers paying for research and research providers have tried to remain competitive in the EU and US markets. Studies have found, for instance, that as a result of MiFID II, there has been a trend towards asset managers paying for research from their own resources. Additionally, many asset managers decreased their research budgets and the number of their research providers, but it is unclear whether this was due to the legislation since this downward trend existed before MiFID II went into effect. Studies have also found that after MiFID II was

¹⁵⁴ Section 106 requires the staff to consider “the impacts of different payment mechanisms for investment research into small issuers” on the provision of and reliance upon such research. Studies cited in this Report that cover this factor are discussed in the context of MiFID II’s impacts on research generally and research costs, and do not otherwise discuss payment mechanisms.

¹⁵⁵ See Liquidnet University, *Unbundling Research: Canary in the Coalmine* (Dec. 10, 2018) (“Liquidnet Research”), available at <https://www.liquidnet.com/expert-insights/unbundling-research-canary-in-the-coalmine> (finding, based on speaking to 62 market participants in a variety of roles across the globe, that “[r]esearch unbundling is already going global—53% of buy-side respondents have already implemented a global policy & a further 20% will do so within the next 5 years” and that “[i]n Europe the change may be regulatory driven, but across the rest of the world it is being led by end investor demand”); see also Andrew Holt, *Mifid II Going Global, Says Research*, IR MAG., Dec. 12, 2018, <https://www.irmagazine.com/regulation-mifid-ii/mifid-ii-going-global-says-research> (citing Liquidnet Research revealing that “a majority of asset managers are implementing the European rules on research procurement across their worldwide operations, not just in Europe, in response to Mifid II and investor demand”); Siobhan Riding, *US Bundled Equity Commissions Fall by Nearly Half in Decade*, FIN. TIMES, Jul. 14, 2019 (“Riding Article”), <https://www.ft.com/content/40477f19-fffb-3d30-bfbd-4134bb31f416> (“Although Mifid II does not apply to US fund houses, [some] managers . . . have decided to implement it on a global basis, eager to capitalise on increased investor demand for transparent pricing.”).

¹⁵⁶ See Jackson & Zhang, *supra* note 119, at 31.

¹⁵⁷ See *infra* Section VI (discussing research coverage trends).

implemented, research providers competed over research prices that reduced research costs, but this has disadvantaged small research providers more so than large research providers.

1. Payment Mechanisms for Research

Studies have found that as a result of MiFID II, there has been a trend towards asset managers subject to the legislation paying for research from their own resources – rather than from their clients’ assets through an RPA – in order to remain competitive,¹⁵⁸ for administrative convenience¹⁵⁹ and/or to obtain tax benefits.¹⁶⁰ Studies have also shown that this general trend was seen in the months leading up to the MiFID II implementation date¹⁶¹ and may have been

¹⁵⁸ See, e.g., EC, *The Impact of MiFID II on SME and Fixed Income Investment Research* 10 (Apr. 2020) (“EC Report”), available at <https://www.riskcontrollimited.com/wp-content/uploads/2020/10/The-Impact-of-MiFID-II-Rules-on-SME-and-Fixed-Income-Investment-Research.pdf> (“Faced with implementing MiFID II rules in 2017, almost all large asset managers [in the EU] chose to pay for research from their own [profit and loss (P&L)] rather than by using RPAs. Survey and interview evidence suggest that the choice was largely influenced by competitive pressures which made it hard for managers to impose new explicit research charges on their clients.”); Jacqueline Eli-Namer & Thierry Giami, AMF, *Reviving Research in the Wake of MiFID II: Observations, Issues and Recommendations* 12 (Jan. 2020) (“AMF Report”), available at <https://www.amf-france.org/sites/default/files/2020-02/20200124-rapport-mission-recherche-projet-va-pm.pdf> (“The fund management industry is faced with strong competition, notably from passive management. As a consequence, portfolio asset management companies have had to grant reductions in management fees. They therefore pass this downward pressure on to all their cost centres, and notably the research cost centre, especially if they have chosen to pay for research out of their revenues, which is the case for the broad majority of fund managers.”); Richard Johnson, Greenwich Associates, *Seismic Shifts: The Future of Investment Research* (2018) (“Greenwich Study”), available at <https://www.digitaltrendanalytics.com/wp-content/uploads/2018/11/thomson-reuters-and-greenwich-associates.pdf> (finding that 70% of investment professionals from North America, Europe and Asia who were interviewed were paying for research out of their resources); Mark Lang et al., *MiFID II Unbundling and Sell Side Analyst Research* 6 (Jun. 2019), available at <https://www.stern.nyu.edu/sites/default/files/assets/documents/Lang%20Pinto%20Sul-MiFID%20II%20unbundling%20and%20sell%20side%20analyst%20research.pdf> (noting, based on an examination of analyst activity in the EU and U.S., that the MiFID II’s unbundling approach put “pressure on research payments by fund managers, either because the costs must be justified to investors if passed on, or because they reduce the funds’ profits if absorbed”).

¹⁵⁹ See, e.g., EC Report, *supra* note 158, at 15 (stating that “at a mundane level, some firms reportedly ran out of time to implement the administrative procedures required by RPAs in the run up to the MiFID II implementation date and hence were obliged to pay out of P&L”); Rhodri Preece, CFA Institute, *MiFID II: One Year On, Assessing the Market for Investment Research* (2019) (“CFA Report”), available at <https://www.cfainstitute.org/-/media/documents/survey/cfa-mifid-ii-survey-report.ashx> (“An additional factor behind the decision of firms to absorb these costs is the administrative convenience of doing so. Firms that opt to charge clients must establish research payment accounts, which carry additional regulatory requirements.”).

¹⁶⁰ See, e.g., CFA Report, *supra* note 159 (stating that “booking the research cost against the firm’s profit and loss may confer certain tax advantages”); see also Amrish Ganatra, *Research Payments: Funding Options Explained*, Commcise Software Ltd., May 27, 2016 (“Comcise Article”), <https://www.linkedin.com/pulse/research-payments-funding-options-explained-amrish-ganatra> (discussing pros and cons of using the profit and loss method).

¹⁶¹ See, e.g., CFA Report, *supra* note 159 (stating that “[i]n the months leading up to the introduction of MiFID II in January 2018, industry professionals observed a general trend toward firms opting to pay for research (charged against the firm’s profit and loss) as opposed to charging clients” and that “[o]ne year on, the survey results affirm that trend”); CFA Institute, *MiFID II: A New Paradigm for Investment Research, Investor Perspectives on*

fueled, at least in part, by advisory clients negotiating for the advisers to pay for research and demands for transparency.¹⁶² While it appears that this trend was also seen with respect to asset managers that were not subject to MiFID II, it may not be as prevalent among them.¹⁶³

Studies have further found that some asset managers, including small asset managers that cannot afford to pay for research out of their profit and loss (“P&L”), have created RPAs to pay for research using client funds.¹⁶⁴ This payment mechanism has not been widely used partly because of its complexity¹⁶⁵ and partly for the reasons discussed above; for example, some asset managers have chosen to pay for research out of their P&L to remain competitive,

Research Costs and Procurement (2017), available at https://www.cfainstitute.org/-/media/documents/support/advocacy/mifid_ii_new-paradigm-for-research-report.ashx (finding, based on a survey of its European members, that “[m]ost asset management firms intend to absorb research costs rather than charge clients”).

¹⁶² See Sophie Baker, *Trade Associations Call for MiFID II Unbundling Exemptions*, PENSIONS & INVS., May 26, 2020, <https://www.pionline.com/regulation/trade-associations-call-mifid-ii-unbundling-exemptions> (noting that many French clients refuse to pay for research and that “either the asset manager bears the cost of the research or he loses (his) clients”). See also *supra* note 155.

¹⁶³ See J.T. Farley, *MiFID II Turns Two, Second Thoughts and Unintended Consequences*, Spring 2020 (“NIRI Update”), available at https://www.niri.org/NIRI/media/NIRI/IRUpdates/2020%20IR%20Update/Spring2020_NIRI_IRU_Feature4_MiFiDII.pdf (quoting a principal at Integrity Research Associates, which tracks the investment management industry, as saying, “One year ago it seemed like there was a similar movement by U.S. asset managers to decide to pay for research out of their own P&Ls, but after a handful of managers made that move, very few really followed suit.”); Neil Scarth, *Briefing: The Sum of All Fears*, IPE MAG., Feb. 2021, <https://www.ipe.com/home/briefing-the-sum-of-all-fears/10050264.article> (“As a result of the widespread move to fund research budgets through P&L (profit and loss) by European asset managers, the contribution of European asset owners to European manager research costs has plummeted to near zero. In contrast, US asset owners [i.e., clients of managed accounts] continue to fund over 90% of US manager research budgets . . .”).

¹⁶⁴ See, e.g., EC Report, *supra* note 158, at 10 (“Smaller asset managers that adopted RPAs typically have simpler fund structures which make the use of RPAs practically feasible. Moreover, these firms felt that absorbing research costs in P&L was not a viable option for them.”); see also Commcise Article, *supra* note 160 (discussing pros and cons of using RPAs).

¹⁶⁵ See EC Report, *supra* note 158, at 15 (stating that “large firms chose to pay out of P&L because of the complexity they would face in attributing research costs to individual funds when block trades are performed simultaneously for multiple clients using a variety of trading mechanisms”); AMF Report, *supra* note 158 (noting that asset managers may choose to pay for research rather than pass the research costs on to their clients partly because of the regulatory complexity surrounding the establishment of RPAs); FCA, *Implementing MiFID II – Multi-firm Review of Research Unbundling Reforms* (Sept. 19, 2019) (“FCA Report”), available at <https://www.fca.org.uk/publications/multi-firm-reviews/implementing-mifid-ii-multi-firm-review-research-unbundling-reforms> (“Most traditional asset managers have opted to pay for research using their own resources instead of setting up RPAs. There were only a few firms in our sample adopting RPAs, but we found no evidence that these firms were not complying with the rules. We generally saw comparable levels of scrutiny to research payments across both models.”). See also RSRCHXchange, *Global Research Unbundling Survey – Summary Report* (Jun. 2018) (“RSRCHXchange Report”), available at <https://www.sec.gov/comments/mifidii/c15-4919454-178354.pdf> (“Investment firms in Europe have tended toward paying for research from their own resources instead of charging clients due to the regulatory complexity.”).

for administrative convenience, or to obtain tax benefits. When the EC examined the state of research related to small and mid-sized enterprises across the EU countries, and the impact of MiFID II on research, the EC found that “[f]ollowing MiFID II, 96% of the firms responding to the survey reported paying for research out of P&L and 67% said they used RPAs,” which means that some firms took multiple approaches.¹⁶⁶ Generally speaking, the results from these studies appear to be consistent with public reports and comment letters to the Commission on measures to facilitate cross-border implementation of MiFID II’s research provisions, which note that most global asset managers pay for research out of P&L, but some asset managers in the EU may pay for research using RPAs, funded with client assets.¹⁶⁷

a. Research Use

Studies have shown that after MiFID II, many asset managers decreased their research

¹⁶⁶ EC Report, *supra* note 158, at 58 n.41 (“The fact that so many firms clearly use multiple approaches to paying for research may seem surprising. But in practice, a relatively small firm relying mainly on RPAs will typically use P&L to pay for some research related expenses such as data while major firms with global operations typically have a variety of fund management operations. So, while they may predominantly employ P&L, RPAs may be used in some of their activities.”).

¹⁶⁷ *See, e.g.*, Capital Group Letter, *supra* note 144, at 10 (“Several global investment managers, including Capital Group, have implemented policies to bear the cost of research from their own resources, thereby benefitting all clients in the same manner.”); Sidley Austin Letter, *supra* note 144, at 7 (“Driven in large part by MiFID II, global money managers, and in some cases U.S. money managers, have begun requesting U.S. broker-dealers to be able to pay for research with hard dollars.”); Owen Walker, *Mifid II Influence Spreads Beyond EU Borders*, FIN. TIMES, May 3, 2020, <https://www.ft.com/content/6305c265-7549-44b1-801b-b11594134227> (discussing a Liquidnet study, which found that “52 per cent of international investment managers said they had taken the research costs on to their profit and loss globally, with 33 per cent doing so just for Europe”); Justina Lee, *From \$1,600 to \$1 Million: Research Costs Under MiFID II*, BLOOMBERG, Apr. 23, 2019, <https://www.bloomberg.com/news/articles/2019-04-23/from-1-600-to-1-million-what-research-costs-under-mifid-ii> (stating that according to a survey of research providers by U.S. consulting firm Integrity Research Associates LLC in 2019, “[m]edian responses show 60 percent of research revenue was paid in cash [“hard dollars” out of P&L], 30 percent in commission sharing agreements [using bundled commissions] and 10 percent from directed commissions [an EU-type arrangement between an executing broker and research provider]”). *Cf.* AIMA, *Payment for Research After MiFID 2: Hedge Fund Industry State of Play*, Jul. 2018, available at <https://www.sec.gov/comments/mifidii/cl15-4940120-178467.pdf> (global trade association finding, based on a survey of 34 members, that more asset managers pay for fixed income research out of their P&L than RPAs whereas more asset managers pay for equity research out of their RPAs).

budgets¹⁶⁸ and the number of their research providers.¹⁶⁹ This decline, however, may have been

¹⁶⁸ See EC Report, *supra* note 158, at 10 (“The average asset manager budget for external equity research fell between 2017 and 2019 by around 20-30%. The decline was concentrated in the budgets of larger firms (with the most sizeable firms reducing their research budgets by 30-40%) and was partially offset by higher spending on credit research and, possibly, by an increase in internal research costs. SME equity research expenditures also declined but not by as much as expenditures on Large Cap equity research.”); CFA Report, *supra* note 159, at iv (finding, based on a survey of its European members, that “[r]esearch budgets have been scaled back, with the largest firms making the biggest budget reductions”); AMF Report, *supra* note 158 (finding that asset managers decreased their research budgets by 25% to 50% in 2018 and by a further 30% to 50% in 2019); FCA Report, *supra* note 165 (finding that “[i]rrespective of payment approaches, firms have reduced their research expenditure” and that there was “a material reduction of around 20%-30% in the budgets firms set for externally produced equity research”); Rebecca Healey et al., Liquidnet University, *MiFID II Unbundling Research: Canary in the Coalmine II* (Apr. 2019), available at https://static1.squarespace.com/static/5bedbc974eddecfbfb0c217e/t/5cb8d43d8165f5922b1b7211/1555616829739/LNU_Canary+in+a+Coalmine+II_DIGITAL180419.pdf (finding, based on interviewing market participants in the U.K., EU and U.S., that “[o]verall research spend has decreased for 39% of respondents; it has remained constant for 48% of asset managers who are instead choosing to re-align budgets, and 13% are now choosing to increase their research spend”). See also Annabel Smith, *Banks Lose 7,500 Years of Analyst Experience Since MiFID II Unbundling*, THE TRADE, Mar. 9, 2021, <https://www.thetradenews.com/banks-lose-7500-years-of-analyst-experience-since-mifid-ii-unbundling/> (citing a report that found that “virtual meetings during the pandemic had driven down the value of analyst research by almost half” and that “40% of asset managers [surveyed] said they had recalculated and reduced pre-agreed research budgets due to uncertainty and structural changes in research consumption”); Hugh Leask, *How the MiFID II Review and Covid-19 are Reshaping the Hedge Fund Operational Landscape*, HEDGEWEEK, Oct. 11, 2020, <https://www.hedgeweek.com/2020/11/10/292019/how-mifid-ii-review-and-covid-19-are-reshaping-hedge-fund-operational-landscape> (“Almost three years on, industry consensus indicates MiFID II has led to a reduction in hedge fund research spend. But anecdotal evidence also suggests portfolio managers have sought to capitalise on the reduced amount of stock analysis with targeted research budgets to help them gain an edge.”); Helen Reid et al., *Pressure on Small Brokers Grows a Year After New EU Rules*, REUTERS, Jan. 2, 2019 (“Reid Article”), <https://www.reuters.com/article/us-eu-markets-mifid-brokers-analysis/pressure-on-small-brokers-grows-a-year-after-new-eu-rules-idUSKCN1OW0FB> (discussing Greenwich Associates research showing that “average budget cut by asset managers of about 20 percent in 2018, with a reduction of another 5 percent to 6 percent expected in 2019”); Andrew Holt, *US Buy Side Sees Impact of Mifid II, Reveals Study*, IR MAG., Aug. 7, 2019, <https://www.irmagazine.com/regulation-mifid-ii/us-buy-side-sees-impact-mifid-ii-reveals-study> (citing study by consulting firm TABB Group finding that MiFID II has “caused the US commission pool to plummet”).

¹⁶⁹ See, e.g., Ivy Schmerken, *MiFID II Research Unbundling Spreads Uncertainty to the U.S.*, Jul. 11, 2019, <https://flextrade.com/mifid-ii-research-unbundling-spreads-uncertainty-to-the-u-s/> (“As a result of opting to pay for research themselves, many buy-side firms have slashed the number of research broker providers. A large firm that may have had 200 research providers has cut the number to 150, though that is still a large number.”); AMF Report, *supra* note 158 (discussing how “the majority of companies have carried out a stricter selection of research providers”); Quoted Companies Alliance / Peel Hunt, *MiFID II: The Search for Research, Mid and Small-Cap Investor Survey* (Feb. 2019) (“QCA Survey”), available at https://www.theqca.com/article_assets/articledir_356/178156/QCA-Peel_Hunt_Investor_Survey_2019_Report.pdf (finding that the majority of fund managers surveyed saw their list of research providers decrease as a result of MiFID II); Liquidnet Research, *supra* note 155 (finding that “61% of asset managers have reduced [the] number of research providers”); Scott Davis & Carter Copeland, *A Year Into MiFID II*, Melius Research, Nov. 23, 2018 (“Melius Research”), available at <https://www.sec.gov/comments/mifidii/cll5-5102588-183266.pdf> (“Unsurprisingly, in response to both declining assets under management in actively managed investment funds and the challenges that have been brought on by the adoption of MiFID II for global asset managers, the industry has responded by cutting down its number of suppliers. In many instances going from 80+ to ~30-35.”). See also David Whitehouse, *Reviving Research in an Unbundled World*, THE TRADE, Mar. 23, 2020 (“Whitehouse Article”), <https://www.thetradenews.com/reviving-research-unbundled-world/> (stating that “the AMAFI association

a continuation of a downward trend that existed before MiFID II.¹⁷⁰ The reduction in research expenditures may be attributed to, among other factors, asset managers paying for research out of their own pockets, asset managers adopting a more targeted and efficient approach to obtaining and using research, a reduction in redundant analyst coverage and competition driving down the costs of research.¹⁷¹ Some studies have also found a trend towards asset managers insourcing research or supplementing external research with in-house research.¹⁷² Some of these trends may suggest that analysts, particularly sell-side analysts, are covering some issuers

of French market professionals reported in September a ‘large consensus among issuers, asset management companies and research providers’ that the total amount paid for research has dramatically diminished and is set to continue to fall, with the decline particularly severe for small- and mid-caps”).

¹⁷⁰ See Riding Article, *supra* note 155 (“According to Greenwich Associates, average bundled equity commissions in the US are down by nearly half in the past decade. Greenwich estimated that the research component of these commissions had declined particularly sharply in the past three years, falling from about \$6bn in 2016 to \$3.6bn in 2019.”); Michael Mayhew, *2019 Research Analyst Headcount Shrinks by 8%*, Dec. 30 2019, <https://www.mag Yates.com/blog/2019-research-analyst-headcount-shrinks-by-8/> (citing data by consulting firm Coalition Development showing that “research analyst headcount at the twelve largest investment banks dropped 8% to 3,500 by the middle of 2019 across 12 of the largest investment banks,” but noting that “this decline has merely been the continuation of a longer-term trend in shrinking analyst headcount” well before MiFID II).

¹⁷¹ See, e.g., FCA Report, *supra* note 165 (stating that “[b]uy-side firms are paying less for research by having a more targeted approach to procurement and increased efficiency in the way they use research, such as fewer and more focused analyst meetings,” “[c]ompetition is driving down costs for written material” and “[m]ost firms are adopting formal processes to set their research budgets, and increasing their efforts to better understand how they use their research to improve cost discipline”); Brunswick Group, *MiFID II: The Impact on FTSE 250 Companies* (Autumn 2018), available at <https://www.brunswickgroup.com/media/4944/mifid-ii-impact-on-ftse-250-companies-final.pdf> (advisory firm noting that many asset managers in the U.K. who pay separate for research out of their own budget, as a result of MiFID II, have cut back their consumption of research); Guo & Mota, *supra* note 111, at 98 (“In practice, since it is difficult to justify the exact value of each research service to clients, and since asset managers want to compete for investors, most asset managers have decided to charge research costs against their own profits. Internalizing research costs makes asset managers more selective, thus reducing the research services they choose to purchase.”); Greenwich Study, *supra* note 158, at 6 (finding that 43% of investment professionals interviewed “expect to further increase their reliance on proprietary in-house research, and 39% anticipate being more reliant on independent research providers”); Jackson & Zhang, *supra* note 119, at 5 (finding that “MiFID II has lowered the aggregate level of analyst coverage with respect to large companies—through reduced redundancy—but not with respect to small- and medium-sized companies”).

¹⁷² See, e.g., AMF Report, *supra* note 158, at 13 (noting that “a trend towards insourcing of research” has contributed to a further reduction in research demand); Bingxu Fang et al., *The Effects of MiFID II on Sell-Side Analysts, Buy-Side Analysts, and Firms*, 25 REV. ACCT. STUD. 855 (2020) (“Fang et al.”) (finding “strong evidence that the number of buy-side analysts increase[d] following MiFID II, suggesting that European investment firms turn[ed] to more in-house research after the implementation of the new regulation”).

in less depth or not at all,¹⁷³ but whether this is primarily due to MiFID II is open to debate.¹⁷⁴

b. Issuer-Sponsored Research

The staff understands that in recent years, there has been an increase globally in small issuers paying for, or sponsoring, research analysts to cover the issuers in order to be on investors' radar and enhance the issuers' credibility so that they can raise capital.¹⁷⁵ This increase may have been an unintended consequence of MiFID II to the extent that the legislation made it harder for small issuers to attract research coverage.¹⁷⁶ Investment

¹⁷³ See Julie Steinberg & Paul J. Davies, *Less Research? No Problem, Hedge Fund Says*, WALL ST. J., Jan. 13, 2020, <https://www.wsj.com/articles/less-research-is-no-problem-for-investors-11578918394> (“Many sell-side outfits have scaled back their research as investors have spent less money on it since the rules were implemented. Some investors have built their own in-house research teams. The knock-on effect is analysts are covering some stocks in less depth or not at all. Hedge funds are seizing on this information asymmetry, sniffing out companies that have become cheaper due to their lack of coverage.”).

¹⁷⁴ See Whitehouse Article, *supra* note 169 (stating that “[t]he assumption that small- and mid-cap coverage has suffered as result of MiFID II is open to debate” and discussing different findings to support both sides of the argument). There is at least one limited study, with a one-year follow-up, that suggests that paying out of P&L may impact asset managers' performance, as measured by fund performance. See Glenn Schorr et al., Evercore ISI Research and Frost Consulting, *The Most Self-Serving Research Note Ever?* (Apr. 26, 2019) (“Evercore Study”) (research providers finding that, in 2018, the first full year in which MiFID II's unbundling requirements went into effect, asset managers who chose to pay for research from their own resources purchased less research and underperformed asset managers who adhered to the bundled brokerage commissions model while acknowledging that a review of only one year was too short to be dispositive of long-term performance trends); Glenn Schorr et al., Evercore ISI Research and Frost Consulting, *Another Year of Unintended Consequences* (May 2020) (“Evercore Updated Study”) (research providers finding, in a follow-up study, that U.S. asset managers outperformed their European counterparts who spent less on research). Another study, however, concluded that “empirical analysis, on balance, does not suggest that soft dollar practices improve fund performance,” while acknowledging that “it is difficult to empirically evaluate this hypothesis because researchers do not have a good line of sight into the amount of research funded with soft dollars at the fund level either at the individual fund level or in the aggregate.” Jackson & Zhang, *supra* note 119, at 18-19. See also Justina Lee, *U.S. Managers Are Thumping European Peers. MiFID May Be Why*, BLOOMBERG, May 14, 2020, <https://www.bloomberg.com/news/articles/2020-05-14/u-s-stock-pickers-are-thumping-european-peers-mifid-may-be-why> (discussing Evercore Updated Study while noting that “[i]t's difficult to directly attribute outperformance to a single factor”).

¹⁷⁵ See AMF Report, *supra* note 158, at 18 (“Discussions between the Task Force [formed by AMF to explore ways to mobilize the research marketplace] and market participants have shown that [the] growth [of sponsored research] has accelerated in 2019.”); see also Ksenia Galouchko, *As Stock Research World Shrinks, More Firms Pay to Be Covered*, BLOOMBERG, Aug. 4, 2020, <https://www.bloomberg.com/news/articles/2020-08-04/a-niche-grows-in-research-more-firms-pay-for-their-own-analyst> (discussing the increase of sponsored research and conflict concerns); Nikou Asgari, *Reform Helps To Flip Cost of Research on to Small Companies*, FIN. TIMES, May 7, 2019, <https://www.ft.com/content/f746ed3c-5f84-11e9-a27a-fdd51850994c> (“The appeal for companies to pay [for research] is clear — research by smaller brokerages gives them greater exposure to investors at a time when large fund houses have slashed their research budgets.”).

¹⁷⁶ See CFA Society United Kingdom, *MiFID II: One Year On, An Assessment* (2019), available at <https://www.cfauk.org/-/media/files/pdf/pdf/9-media-centre/mifid-ii-one-year-on.pdf> (identifying issuer-sponsored research as an unintended consequence of MiFID II); see also Ben Ashwell, *Company-Sponsored Research Gains Credibility, Says Experts*, IR MAG., Oct. 9, 2019, <https://www.irmagazine.com/small-cap/company-sponsored-research-gains-credibility-say-experts> (“While Mifid II is a European regulation and effects on issuers still seem

professionals have expressed concerns regarding the credibility of issuer-sponsored research because it may be biased or may not clarify whether such research has been paid for by the issuer or whether the analyst is independent.¹⁷⁷ In response, organizations whose members are investment professionals and corporate officers, as well as at least one foreign regulator, have encouraged the industry to develop best practices governing issuer-sponsored research.¹⁷⁸

2. Research Costs

Studies have shown that after MiFID II was implemented, the global market went through a period during which research providers sought to establish prices for research (“price discovery”) and engaged in a competition over research prices that reduced the costs of research, which benefited investors who paid for the research.¹⁷⁹ It appears, however, that this

largely muted in North America . . . there is a large universe of uncovered or undercovered public companies in the US. With many investment banks adopting Mifid II on a global scale for compliance reasons, there’s an acknowledgement that it’s harder for small and micro-cap companies to attract sell-side research coverage. This speaks to a need for some small and micro-cap companies to invest in company-sponsored research . . .”).

¹⁷⁷ See AMF News Release, *supra* note 42 (encouraging “all stakeholders to work on a charter that presents good practice based on existing regulatory obligations, in particular with respect to ethics and independence”); see also Human Article, *supra* note 42 (indicating that AMF spokesperson noted that some asset managers may have concerns that issuer-sponsored research may be biased or that it is not entirely clear whether such research is paid for by the issuer or whether the analyst is independent, which prompted AMF to encourage industry development of best practices to address potential conflicts of interest).

¹⁷⁸ See *supra* note 42. In the United States, there are regulatory measures that relate to issuer-sponsored research. See, e.g., FINRA, Rule 2241(c)(4)(I) (2015) (requiring disclosure of material conflicts of interest of “the research analyst or member that the research analyst or an associated person of the member with the ability to influence the content of a research report knows or has reason to know at the time of the publication or distribution of a research report”) and Rule 2242(c)(4)(H) (2016) (requiring similar disclosure of material conflicts of interest with respect to debt research analyst). See also *supra* Section IV.A.2 (discussing FINRA Rule 2241).

¹⁷⁹ See, e.g., AMF Report, *supra* note 158, at 14-15 (noting that, in the Paris financial market, commercial negotiation of research was competitive in 2019, “[t]he great majority of research providers are therefore adjusting the price of these services downward,” and “MiFID II has led to the development of a supply of research services at extremely low prices”); CFA Report, *supra* note 159, at 9 (finding, based on a survey of its European members, that “[t]he advent of MiFID II led to a period of price discovery for research products and services”); FCA Report, *supra* note 165 (attributing, based on a study of buy-side firms, sell-side firms and activities in the U.K., the wide range of sell-side research levels to an ongoing process of price discovery of research). See also Andrew Bailey, Chief Executive, FCA, Keynote Speech on MiFID II at the European Independent Research Providers Association (Feb. 25, 2019), available at <https://www.fca.org.uk/news/speeches/andrew-bailey-keynote-speech-mifid-ii-european-independent-research-providers-association> (“The market is going through a period of price discovery, and is probably yet to find an equilibrium.”). Cf. Jackson & Zhang, *supra* note 119, at 47 (“Previously, asset managers in Europe and the United States had been paying for sell-side research services with what was effectively a different currency with a lower value than hard dollars. . . . Under MiFID II, the price of sell-side research services effectively increased as they were either moved to collect hard dollar payments from asset managers or transferred into RPA accounts where the cost of payment became immediately salient to asset owners [i.e., clients of managed accounts]. . . . the price charged for sell-side research, now levied in real currency, has come down and quite dramatically in some cases.”).

competition has disadvantaged small research providers more so than large research providers.¹⁸⁰ At least one study found that research pricing models by investment firms providing execution and research services still varied greatly one year after the implementation of MiFID II,¹⁸¹ while another study found that even two years after the implementation, the pricing of research continued to be competitive, heavily negotiated, and in the “price discovery phase.”¹⁸² In at least two other studies, 75% of those surveyed believed that the low prices charged by research providers at the time were not sustainable, particularly for small independent research providers.¹⁸³ One academic study indicated that as of September 2020, “there has not been a systematic study on how brokerage firms charge for research after MiFID II,” but anecdotal evidence suggested that “the pricing schedule after unbundling is mixed: basic access to research is at a single (subscription fee) and high touch services, such as direct access to analysts, are charged separately at a high premium.”¹⁸⁴ Boutique or independent research providers in the EU, including the U.K. before its withdrawal from the EU, have complained that larger research providers have engaged in predatory pricing and unfair competition, with some rivals charging as little as \$10,000 annually for access to all written research.¹⁸⁵

¹⁸⁰ See, e.g., Siobhan Riding, *Mifid II Creates ‘Existential Threat’ for Small Research Groups*, FIN. TIMES, Dec. 8, 2019, <https://www.ft.com/content/1b7986ca-13e1-4d16-9d8e-37f1136e238e> (“Independent boutiques, which rely almost entirely on the sale of research to survive, have been forced to reduce their pricing in response to the new environment. Nearly two-thirds of providers said they had cut prices in the past 12 months, with houses’ average annual fee falling from \$45,000 to \$30,000.”).

¹⁸¹ See FCA Report, *supra* note 165 (“Firms’ models varied with some using tiered service pricing levels, others offering ‘pay as you go’, while others price per type of interaction or product consumed.”).

¹⁸² See, e.g., NIRI Update, *supra* note 163, at 32 (noting “the aggressive pricing of equity research by some larger investment banks, with some bulge-bracket firms offering full access annually to published research for as little as \$10,000”); see also Reid Article, *supra* note 168 (opining that “pressure on research prices may be here to stay, with asset managers in a strong bargaining position”); European Fund and Asset Management Association, *Position Paper on EC Consultation Paper on Covid-19’s ‘Capital Markets Recovery Package’ – Investment Research for SME and Fixed Income Instruments* (Sept. 11, 2020), available at <https://service.betterregulation.com/document/460379> (noting that the research market is still in the “price discovery” phase).

¹⁸³ See RSRCHXchange Report, *supra* note 165 (research provider surveying over 400 asset management individuals representing 350 firms, including those in the U.S.); QCA Survey, *supra* note 169 (surveying 102 UK-based fund managers and 105 small and mid-sized quoted companies).

¹⁸⁴ Guo & Mota, *supra* note 111, at 100.

¹⁸⁵ Siobhan Riding & Chris Flood, *FCA Attacked by Research Houses Over Mifid II Reforms*, FIN. TIMES, Sept. 19, 2019, <https://www.ft.com/content/dc31af7d-63f3-3927-967e-e320a25d8814> (noting that the pricing environment would likely lead to a review of business models and consolidation opportunities). See also Melius Research, *supra* note 169, at 3 (independent research provider observing price dumping post-MiFID II and stating that “[the large broker-dealer level] of price sets an incredibly low benchmark for the overall market, at ~\$25k for access to written research in Europe, with a la carte pricing for other services on top of this base rate”).

VI. Research Coverage Trends

There are many theories about the factors that most significantly impact the amount of research coverage for small issuers. This Report discusses above¹⁸⁶ the impacts of the Measures and implementation of MiFID II on research, including research on small issuers.¹⁸⁷ Other factors include, for example, the rise of CCAs; a decline in the overall number of IPOs until 2020;¹⁸⁸ falling equity commissions;¹⁸⁹ fewer institutional investors that invest in small

¹⁸⁶ See *supra* Section IV.B (discussing impacts of the Measures on research coverage) and Section V.C (discussing impacts of MiFID II on payment mechanisms and research costs).

¹⁸⁷ See also AMF Report, *supra* note 158 (finding that MiFID II had a negative impact on research coverage in Paris for small and mid-cap issuers); FCA Consultation Paper, *supra* note 152, at 11 (finding that MiFID II has not significantly affected research analyst coverage for smaller UK public companies, but noting that the “average analyst coverage figures mask the fact that a significant proportion of companies at the lower end of the market cap spectrum are without coverage”); Giulio Anselmi & Giovanni Petrella, *Regulation and Stock Market Quality: The Impact of MiFID II Provision on Research Unbundling*, 76 INT’L REV. OF FIN. ANALYSIS 101788 (2021) (finding that “the payment of an explicit price for research is associated with a reduction in analyst coverage in the EU” and “[u]nexpectedly, the reduction is stronger for large-cap stocks”); Fang et al., *supra* note 172 (noting U.S. asset managers’ plans to build their own internal research capabilities and source more research in-house in light of MiFID II and finding “a decrease in the number of sell-side analysts covering European firms after MiFID II implementation”); Cowen Presentation, *supra* note 34, at 14 (discussing Global Settlement and its effect on small cap research). *But see* Adrien Amzallag et al., *MiFID II Research Unbundling Assessing the Impact on SMEs* 3 (ESMA, Working Paper No. 3, 2021), available at https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1269_research_unbundling.pdf (finding, based on analyses of EU sell-side research, that small to mid-cap issuers “continue to be characterised by lower amount of analyst research, higher probability of losing coverage, worse quality of research and limited secondary market liquidity,” but this does not appear to be improved or worsened by MiFID II).

¹⁸⁸ See Jay R. Ritter et al., *Economies of Scope and IPO Activity in Europe*, in *Handbook of Research on IPOs* 11 (Mario Levis eds., 2013) (discussing three alternative explanations for the near-halt of IPO activity in Europe, and similarly in the United States, and finding that the decline in IPO activity has been mainly driven by small issuers); Gao et al., *supra* note 104 (discussing alternative reasons for the dearth of IPOs in the United States).

¹⁸⁹ See *Finding the Best U.S. Small Cap Research Providers*, INTEGRITY RES. ASSOCS. (Sept. 9, 2007), <https://www.integrity-research.com/finding-the-best-us-small-cap-research-providers/> (identifying reasons analyst firms have reduced coverage of small cap issuers, including the rise of CCAs, a decline in IPOs, falling equity commissions and “regulatory changes [that] have put pressures on sell-side and independent research firms”).

issuers;¹⁹⁰ a shift from active to passive investment strategies;¹⁹¹ an increase in reliance on in-house research;¹⁹² and an increase in alternative data sources (e.g., artificial intelligence, machine learning, satellite data, shoppers' data).¹⁹³ The overlapping occurrence of these factors, among many other potential factors, makes measuring the individual effect of each on

¹⁹⁰ Ehren Stanhope & Chris Meredith, O'SHAUGHNESSY ASSET MGMT., *Inefficiency Breeds Opportunity in Small Cap Equities* 1 (2015), https://www.osam.com/pdfs/whitepapers/4_Commentary_InefficiencyBreedsOpportunitySmallCapEquities.pdf (noting that “institutional ownership in small cap tends to be very low” and that “[i]ssues with liquidity and the ability to make investments in size tend to push institutions away from small cap names”); Punch & Associates, *True Small Cap Investing: An Institutional Blind Spot?* (2017) (SEC-registered investment adviser discussing some of the reasons that asset managers may not invest in small issuers, but noting the potential benefits in doing so); Garnet Roach, *Institutional Investment Drops at Small-Cap Companies*, IR MAG. (Mar. 1, 2017) (discussing the results of a survey of investor relations professionals, including a finding that there was “a continuing decline in levels of institutional investment into small-cap companies globally” while “the proportion of shares held by retail investors has remained the same, at 28 percent of the investor portfolio – by far the largest retail ownership across the different cap sizes measured”). *But see* OASB 2021 Annual Report, *supra* note 10, at 38 (finding that small public companies saw an increasing number of retail investors in 2020 and 2021).

¹⁹¹ *See generally* Kenechukwu Anadu et al., *The Shift from Active to Passive Investing: Potential Risks to Financial Stability?* (Bd. of Governors of the Fed. Res. Sys., Working Paper No. 2018-060, 2018), <https://www.federalreserve.gov/econres/feds/files/2018060pap.pdf> (discussing the shift from active to passive investment strategies, which use rules-based investing to track and index, and the impacts of the shift on financial stability).

¹⁹² *See* Madison Marriage, *Banks Lose Business as Buyside Brings Research In-house*, FIN. TIMES, Aug. 10, 2014, <https://www.ft.com/content/88517bdc-1efb-11e4-9d7d-00144feabdc0> (“Fund managers are increasingly carrying out their equity research in-house as criticism grows about the quality and cost of research conducted by bank analysts.”).

¹⁹³ *See generally* Zsolt Katona et al., *On the Capital Market Consequences of Alternative Data: Evidence from Outer Space* (2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3222741 (discussing alternative data in capital markets such as satellite data, which can increase information asymmetry among market participants); Financial Stability Board, *Artificial Intelligence and Machine Learning in Financial Services, Market Developments and Financial Stability Implications* (Nov. 2017), available at <https://www.fsb.org/wp-content/uploads/P011117.pdf> (discussing the rapidly evolving use of artificial intelligence and machine learning in the financial services industry). *See also* Feng Chi et al., *The Use and Usefulness of Big Data in Finance: Evidence From Financial Analysts* (Apr. 2021), available at https://bhwang.com/pdf/14_big-data.pdf (identifying alternative data categories used by sell-side analysts, including “app usage, sentiment, employee, geospatial, point of sale, satellite image, [and] web traffic”); Leslie Picker et al., *How Hedge Fund Investors Are Making Money Off the Data You're Giving Them for Free*, CNBC, Apr. 24, 2019, <https://www.cnbc.com/2019/04/23/how-hedge-funds-use-alternative-data-to-make-investments.html> (discussing the increased use of alternative data, such as shoppers' data, by asset managers to get an edge); Robert C. Pozen & Jonathan Ruane, *What Machine Learning Will Mean for Asset Managers*, HARV. BUS. REV., Dec. 3, 2019, <https://hbr.org/2019/12/what-machine-learning-will-mean-for-asset-managers> (discussing the benefits and limitations of machine learning and noting that, as of 2019, few portfolio managers used machine learning tools).

the research coverage of small issuers in the aggregate inherently difficult to quantify with precision.¹⁹⁴

Despite the difficulty of identifying causal linkages, as discussed and shown in the figures below, the staff’s analysis of data concerning research coverage in recent years (i.e., from 2016 to 2020) does indicate certain observable trends.¹⁹⁵ For example, the number of analysts providing research coverage has declined in recent years. Despite this, the percentage of issuers receiving research coverage has been relatively consistent during most of this time. More noteworthy, the staff observed that small issuers are less likely than large issuers to be covered by research and that the availability of research coverage and the number of analysts covering an issuer correlate with market capitalization.

All results presented in this section and the Appendix are limited to the data contained in the two relevant databases available to the staff – the Center for Research in Security Prices database (“CRSP”) (containing information on issuers with exchange-listed stocks) and the Institutional Brokers’ Estimate System database (“IBES”) (containing information on analysts and research coverage).¹⁹⁶

A. Recent General Trends

In recent years, the number of analyst firms has declined from 325 in 2016 to 305 in 2019, but has since increased slightly to 314 in 2020 (See Figure 1a). Meanwhile, the number

¹⁹⁴ See Mola et al., *supra* note 35, at 672 (noting that, in the context of regulatory reforms, “[t]he enactment of all these regulations over a short period makes it virtually impossible to analyze the incremental impact of the loss of coverage on firms from any one regulation”).

¹⁹⁵ See *supra* note 11 (discussing the limitations of the staff’s data analysis).

¹⁹⁶ Specifically, the results are based on the exchange-listed common stocks, real-estate investment trusts (“REITs”), foreign private issuers, foreign incorporated firms, and master limited partnerships tracked in CRSP combined with matching research coverage data in IBES. When data is unavailable in IBES for an issuer in CRSP, the issuer is assumed to have no analyst coverage. Exchange-traded funds (“ETFs”), closed-end funds, and commodity pools are excluded from the staff’s analysis because these issuers typically lack research coverage. IBES (Source: Thomson Reuters) is a widely-used commercial equity research database available from Refinitiv, one of the world’s largest providers of financial markets data, which includes sell-side analysts’ and select independent analysts’ forecasts of company earnings, cash flows, and other important financial items, as well as buy-sell-hold recommendations. IBES gathers information on over 18,000 issuers in 60 countries from more than 7,000 analysts at over 1,000 analyst firms. See *A Guide to Understanding I/B/E/S Terms and Conventions, The I/B/E/S Glossary 2000*, available at https://financelab.rotman.utoronto.ca/resources/research-databases/Docs/IBES_Glossary%202000.pdf. IBES does not include information on buy-side analysts and only a small fraction of independent analysts contribute to the database. CRSP, which is generally viewed as the gold standard for academic research and industry professionals, maintains the most comprehensive collection of security price, return, and volume data for approximately 26,500 exchange-listed stocks. The CRSP data referenced here is based on data from database name ©2021 Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business.

of analysts providing coverage for any issuer (i.e., small issuers and large issuers) has consistently declined from 3817 in 2016 to 3420 in 2020 (See Figure 1b). As such, the average number of analysts per analyst firm has decreased in recent years (See Table 1 in the Appendix). However, over the same period, the median number of issuers covered per analyst firm has remained mostly consistent around 16 (See Figure 1c).

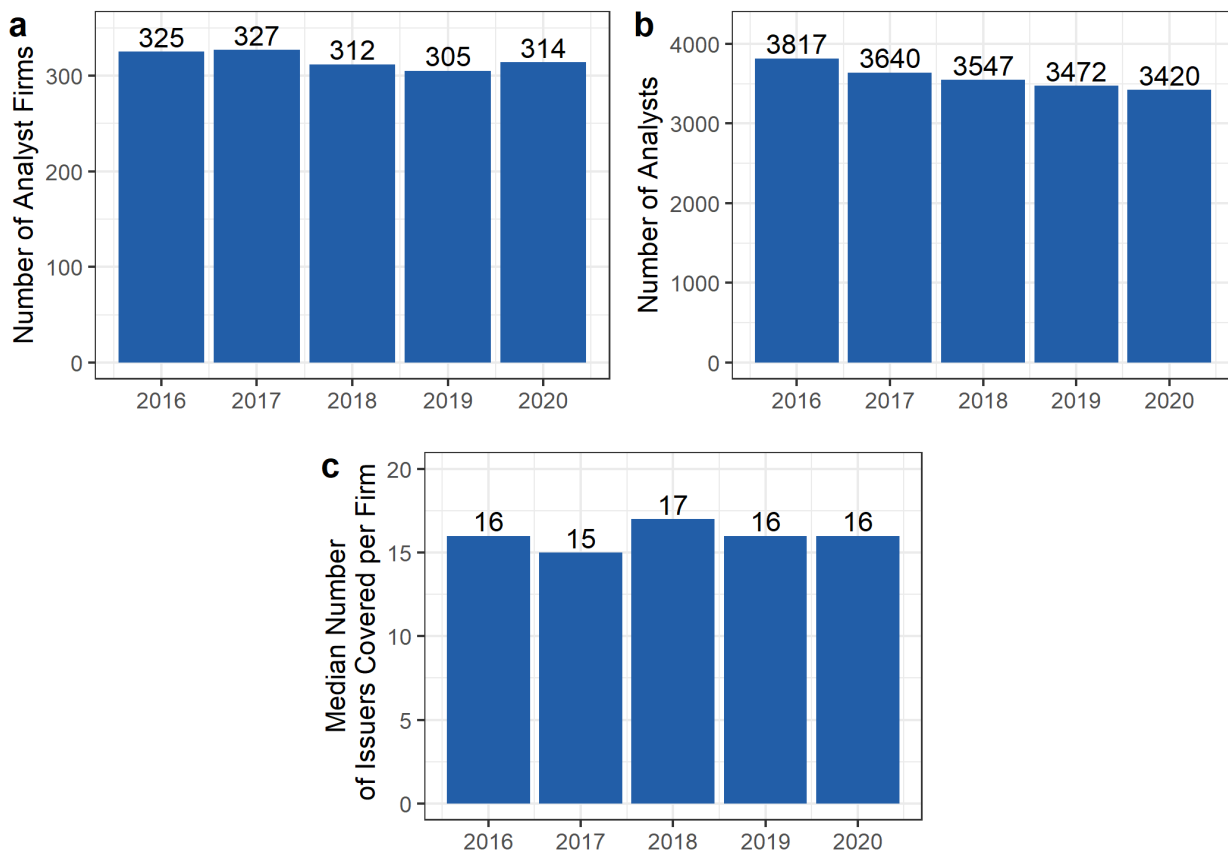


Figure 1. Recent trends in analyst firms and analysts’ research coverage. This figure shows the following trends from 2016 to 2020: a) Number of analyst firms providing research coverage for any issuer; b) Number of analysts providing research coverage for any issuer; and c) Median number of issuers covered per analyst firm.

From 2016 to 2019, even though the number of analyst firms and analysts declined, the percentage of issuers receiving research coverage was relatively consistent; this is possible because an issuer can be covered by multiple analyst firms. Approximately 82.5% of all issuers received coverage by at least one analyst firm during this period (See Figure 2a). In 2020, however, research coverage clearly declined – only 76.9% of issuers received coverage. Research coverage also declined in absolute numbers in 2020 – 4245 issuers received coverage in 2019 compared to 4113 issuers that received coverage in 2020 (See Figure 2b).

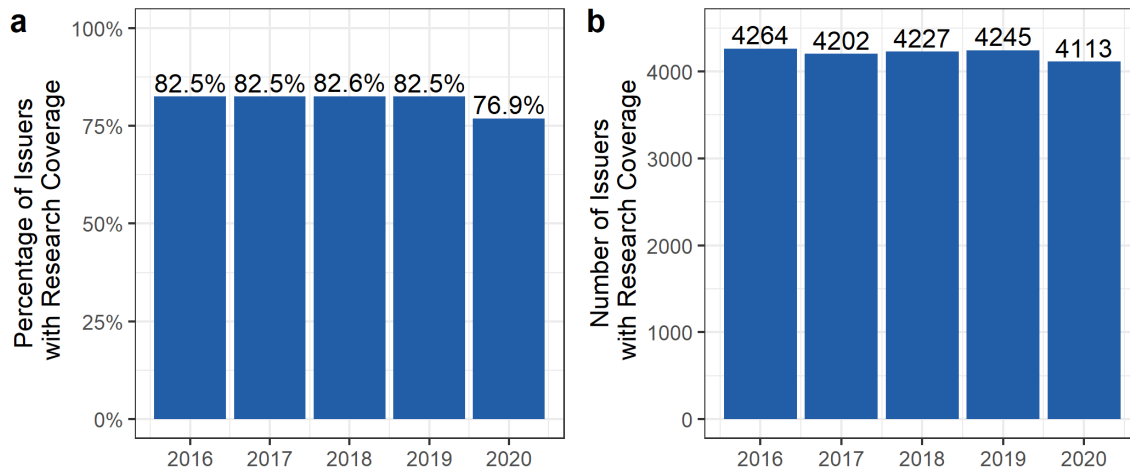


Figure 2. Recent trends in research coverage received by issuers. This figure shows the following trends from 2016 to 2020: a) Percentage of all issuers that received research coverage by any analyst firm; and b) Number of issuers that received coverage by any analyst firm.

It is unclear if deviations in 2020 data from prior years' data are the result of a long-term trend or short-term factors. For example, these deviations may have resulted from disruptions to analyst coverage related to the COVID-19 pandemic as “stay-at-home orders” may have disrupted analyst firms' ordinary courses of business.¹⁹⁷ It also may reflect that 2020 witnessed a significant increase in IPOs generally and IPOs of special purpose acquisition companies (“SPACs”) in particular over prior years, which resulted in a significant net increase in the number of exchange-listed stocks from 5145 in 2019 to 5348 in 2020 (see Table 2 in the Appendix).¹⁹⁸ SPACs that have not yet announced merger plans may receive little to no research coverage; the high proportion of 2020 IPO activity attributable to SPACs is a likely contributor to the observed overall decrease in research coverage of all issuers from prior years.

B. Coverage Trends by Issuer Size

The staff also examined research coverage trends by issuer size.¹⁹⁹ Based on the staff's analysis of data, it appears that research coverage generally correlates with market capitalization

¹⁹⁷ For example, analysts may have been reluctant to initiate coverage on certain issuers without the ability to make in-person visits to the issuer's facilities or have face-to-face meetings with management.

¹⁹⁸ In 2020, there were 494 IPOs, half of which were SPACs. See Sara B. Potter, *U.S. IPO Market: SPACs Drive 2020 IPOs to a New Record*, FACTSET (Jan. 7, 2021), <https://insight.factset.com/u.s.-ipo-market-spacs-drive-2020-ipos-to-a-new-record>; see also OASB 2020 Annual Report, *supra* note 9, at 33 (noting a 51% increase in IPOs and 81% increase in IPO proceeds in the first three quarters of 2020 compared to 2019).

¹⁹⁹ See *supra* Section I.B (defining “small issuers” and “large issuers”).

of issuers such that issuers with small market capitalization were less likely to have research coverage than issuers with large market capitalization.²⁰⁰ This trend is apparent in the figures below.

For instance, the staff plotted the distribution of issuers by market capitalization for issuers with research coverage and those without research coverage for 2019²⁰¹ (See Figure 3). While there is certainly some overlap in market capitalization among the two groups, issuers without coverage tend to have lower market capitalization than those with coverage, as reflected by the differences in the median in the figure. The median market capitalization for issuers without coverage (near \$50M) is considerably lower than the median market capitalization for issuers with coverage (\$1B).

The staff also plotted the average number of analyst firms covering issuers along the entire range of market capitalization for 2019 (See Figure 4). The figure shows a clear trend that issuers with larger market capitalization are covered by more analyst firms on average.

²⁰⁰ In addition to market capitalization, the staff examined revenue as a metric of issuer size and observed a similar correlation between issuer size and the availability of research coverage. However, the staff ultimately decided to utilize the market cap metric in its data analysis, figures and tables to be consistent with the definition of “small issuers” in the SEC Small Business Advocate Act of 2016. *See supra* note 9 (defining “small issuers” and “large issuers”).

²⁰¹ When examining a trend within a particular year, the staff used 2019 because it is the most recently available data where research coverage appears generally consistent with previous years. In 2020, research coverage declined compared to previous years and it is unclear if this is the result of a long-term trend or short-term factors. *See supra* Section VI.A (discussing recent coverage trends).

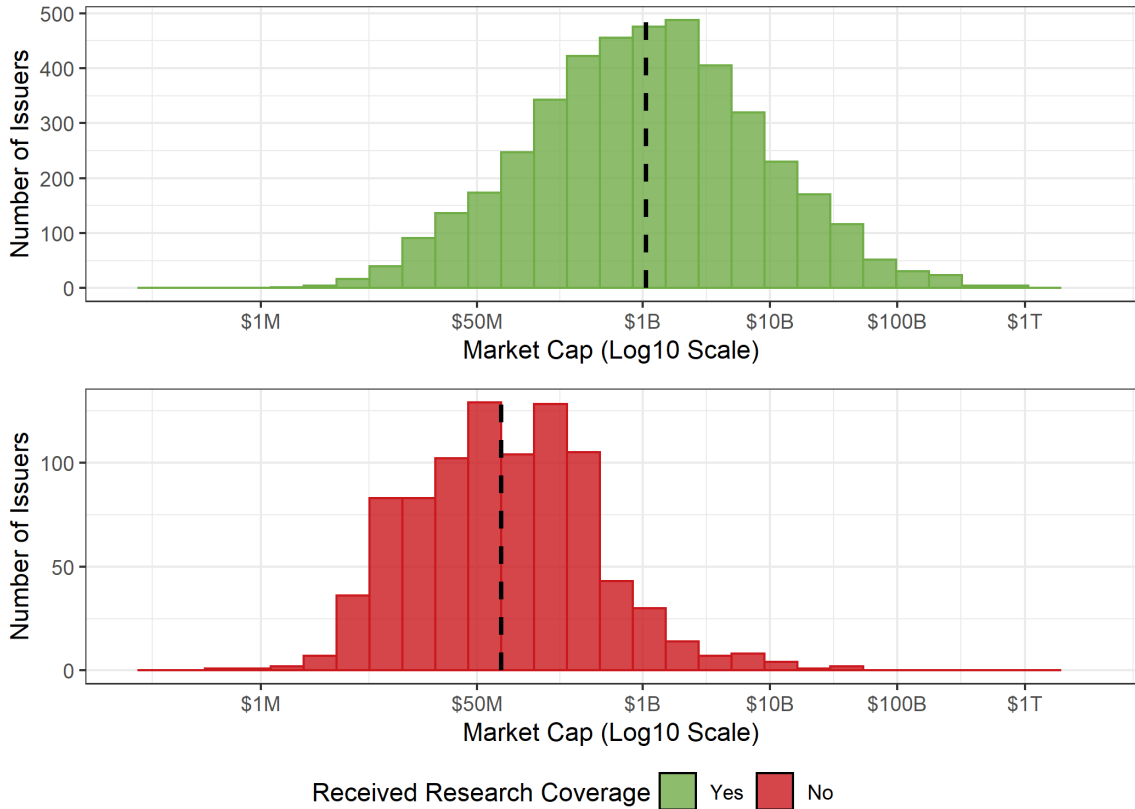


Figure 3. Distribution of issuers by market capitalization for issuers with and without research coverage. This figure shows the number of issuers by market capitalization (on the log10 scale²⁰²) separated by whether or not the issuers received research coverage in 2019. If an issuer received research coverage by at least one analyst firm in 2019, then that issuer is included in the top chart; issuers that did not receive coverage in 2019 are included in the bottom chart. The vertical axis in the top chart (“Number of Issuers”) has a significantly larger scale than the vertical axis in the bottom chart and should not be interpreted to mean that the two charts are drawn vertically to the same scale. Finally, the vertical dashed line represents the median market capitalization among issuers included in each chart.

²⁰² The base 10 logarithmic scale (“log10 scale”) is a commonly used method of displaying data over a very wide range of numerical values in a compact way. Transforming values from the standard linear scale to the log10 scale does not change their relative order, but does change the interpretation of differences between values. In the log10 scale, one unit difference is associated with a numerical increase by a factor of 10 rather than a factor of 1. The staff choose to display market capitalization on the logarithmic scale because it varies from a few million dollars up to over a trillion dollars.

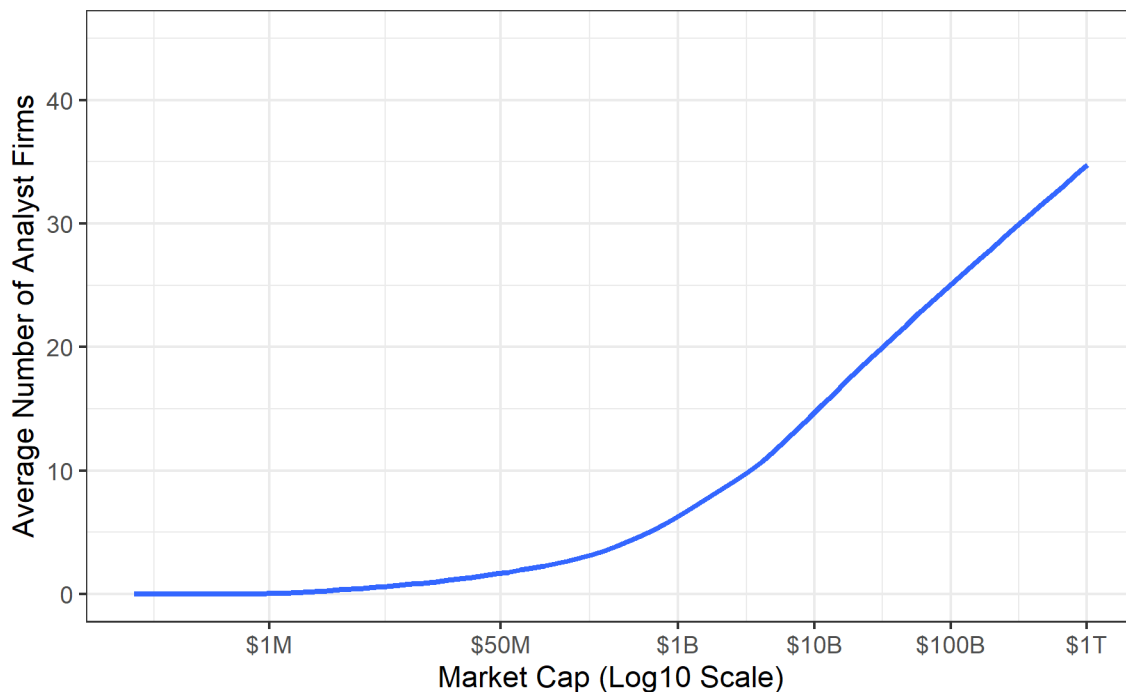


Figure 4. Number of analyst firms providing research coverage of issuers by market capitalization. This figure shows the average number of analyst firms covering an issuer by market capitalization (on the log10 scale) in 2019. For example, an issuer with a market capitalization of \$1 billion was covered by approximately 6 analyst firms on average in 2019 while an issuer with a market capitalization of \$50 million was covered by approximately 2 analyst firms on average.

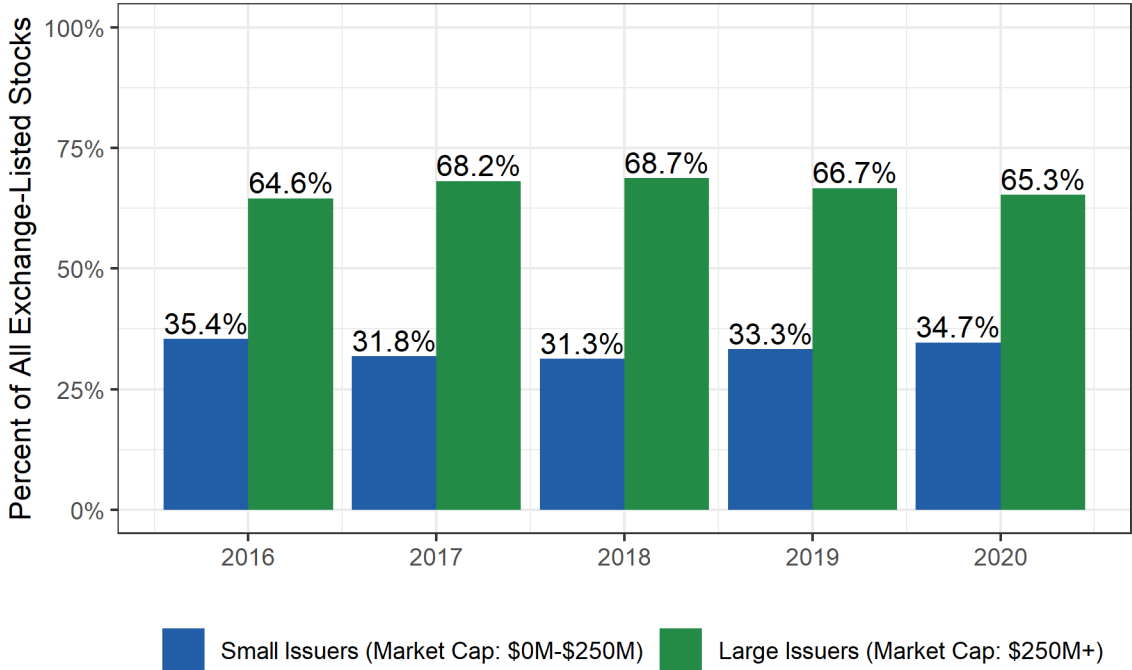
In recent years, small issuers constitute approximately one third of all issuers (See Figure 5). Over the same period, approximately 60% of small issuers received research coverage while approximately 90% of large issuers received coverage (See Figure 6a).

While both small issuers and large issuers experienced a decline in research coverage in 2020 compared to previous years,²⁰³ the decline was more pronounced for large issuers. For example, approximately 57.8% of small issuers had research coverage in 2020 compared to 60.8% in 2019 while 87.3% of large issuers had research coverage in 2020 compared to 93.6% in 2019 (See Figure 6a).

Furthermore, from 2016 to 2020, the average number of analyst firms covering small issuers declined very slightly overall, but in an inconsistent pattern (See Figure 6b). In contrast, the average number of analyst firms covering large issuers over the same period exhibited a

²⁰³ See *supra* Section VI.A.

much more consistent and pronounced decline (See Figure 6b).²⁰⁴ During this period, small issuers received coverage by approximately two analyst firms on average while large issuers received coverage by approximately nine analyst firms on average (See Figure 6b).



²⁰⁴ For additional information, see Table 3 in the Appendix.

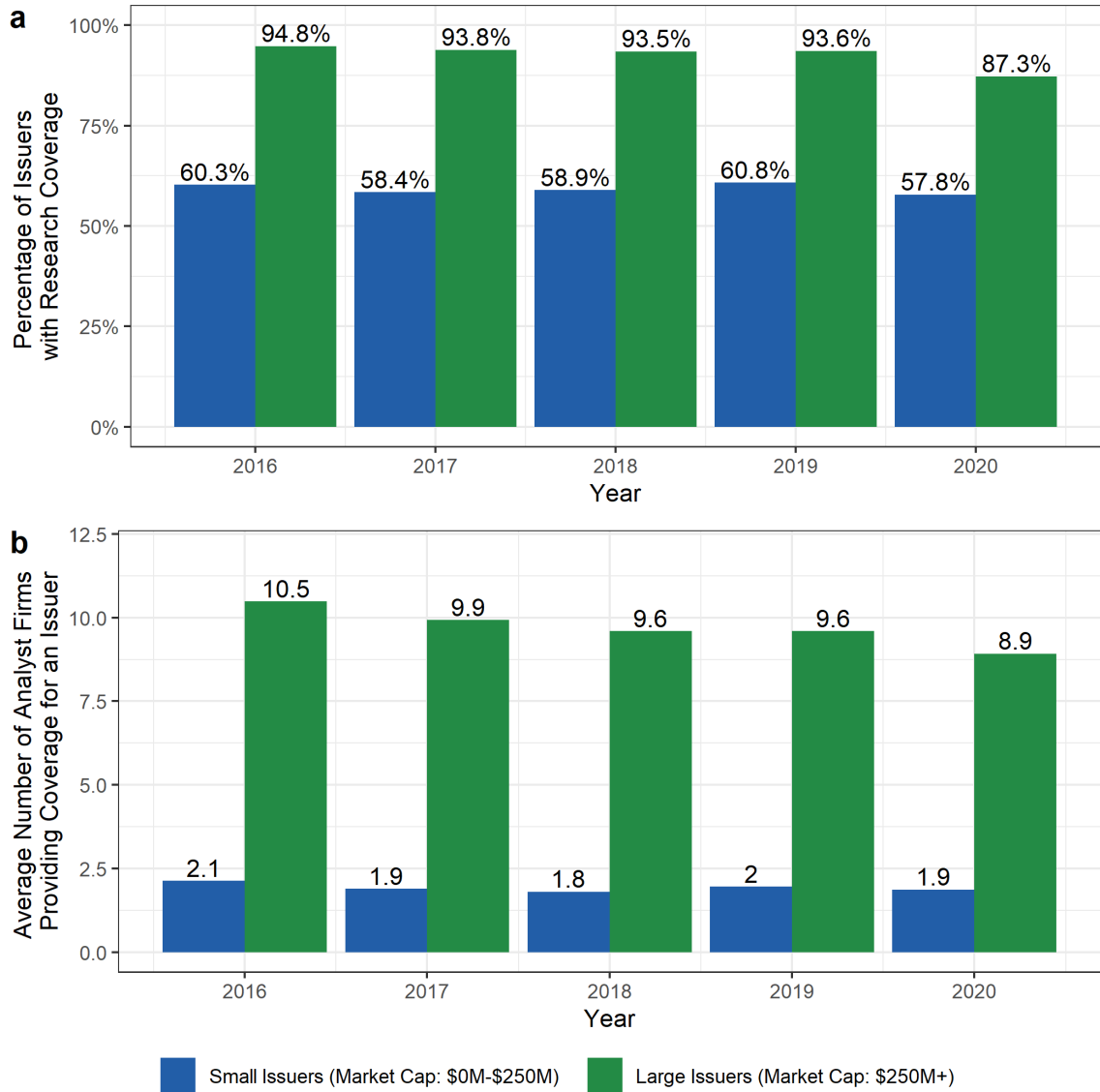


Figure 6. Research coverage for issuers by size. This figure compares research coverage for small and large issuers from 2016 to 2020: a) Research coverage for small issuers and large issuers are measured separately in percentages; and b) Each issuer was covered by up to a maximum of 55 analyst firms in any given year. The number of analyst firms was averaged by year for small issuers and large issuers.

Sorting issuers into groups based on percentiles of market capitalization²⁰⁵ reveals granular insights into the research coverage trends by issuer size.²⁰⁶ From 2016 to 2020, the trend in the percentage of issuers that had research coverage for small issuers in the smallest two groups (i.e., the 0th to 10th and 10th to 20th percentile groups, or roughly the smallest half of small issuers) exhibited no consistent pattern, but the percentage of issuers with coverage was still slightly higher in 2020 than it was in 2016 in both groups. In contrast, over the same period, the percentage of issuers with research coverage in the 20th to 30th and 30th to 40th percentile groups (i.e., roughly the largest half of small issuers) declined sharply (See Figure 7). Across most market capitalization percentile groups for both small and large issuers, there was an overall decline in coverage from 2016 to 2020 both in the percentage of issuers receiving research coverage and the average number of analyst firms providing coverage for an issuer with the steepest decline occurring in 2020 (See Tables 4a and 4b in the Appendix).

²⁰⁵ The specific ranges (in dollar amount) for each market capitalization percentile, or decile, changed every year from 2016 to 2020. The specific ranges for each decile shown in Figure 7 are detailed in Table 4c in the Appendix.

²⁰⁶ The market capitalization cutoff that separates small issuers from large issuers fell within the fourth decile of market capitalization percentile (i.e., 30th to 40th percentile) for every year shown in Figure 7. Because the fourth decile does not perfectly line up with this cutoff, the fourth decile includes large issuers.

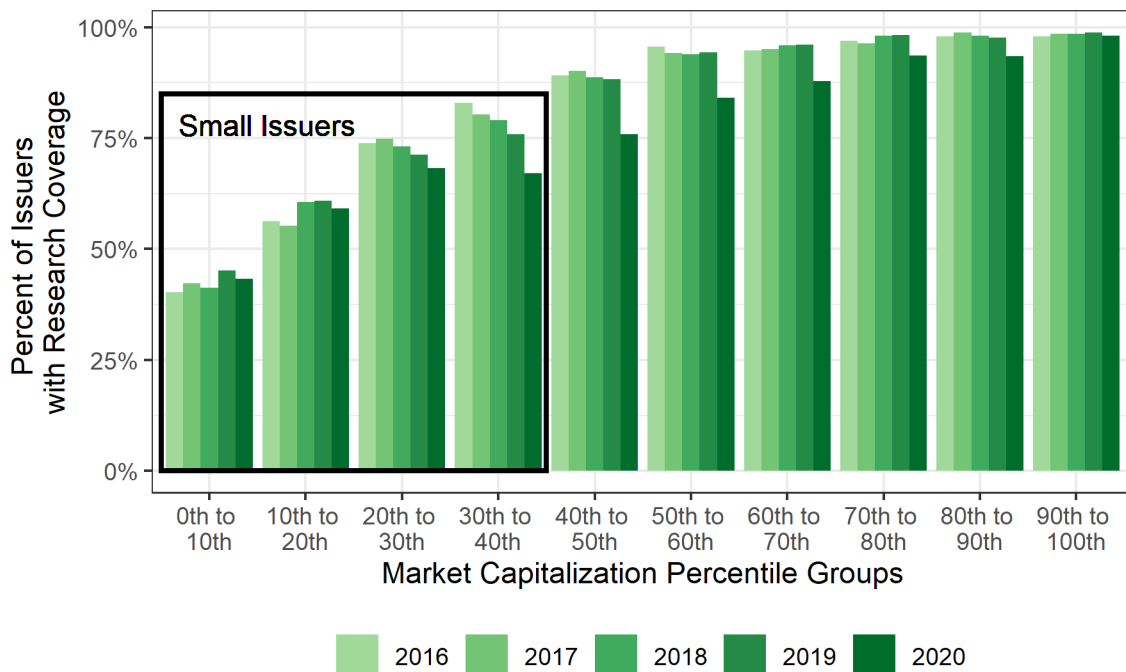


Figure 7. Research coverage of issuers by market capitalization percentile groups. This figure shows the percent of issuers within each market capitalization percentile group that had research coverage from 2016 to 2020. For example, in 2020, approximately 40% of issuers with market capitalization in the 0th to 10th percentile had research coverage while over 90% of issuers with market capitalization in the 90th to 100th percentile had research coverage.

VII. Recommendations

Notwithstanding potential conflicts of interests related to research,²⁰⁷ quality research serves an important and beneficial function in the U.S capital markets.²⁰⁸ There is substantial evidence regarding the benefits of research coverage of issuers, in particular its role in increasing stock liquidity and providing an external governance mechanism on issuer management.²⁰⁹ Research coverage may be particularly important for a small issuer that seeks to increase its stock liquidity or gain investors’ recognition.

Given the benefits of research coverage to small issuers in particular, the staff believes that it is important to identify, evaluate, and where appropriate, address some of the challenges

²⁰⁷ See *supra* Section III (discussing conflicts of interest related to research).

²⁰⁸ See *supra* Section II.B (discussing the importance and benefits of research, including the benefits of multiple analysts covering a single issuer).

²⁰⁹ See *id.*

that small issuers may face in obtaining research coverage. The staff's data analysis suggests that small issuers appear to be less likely than large issuers to be covered by research. Specifically, the availability of research coverage and the number of analysts covering an issuer correlate with market capitalization. The staff's evaluation of these issues has also identified a number of factors that may impact the availability of research coverage of small issuers, including the Measures addressing potential conflicts of interest associated with research, the implementation of MiFID II, and other variables, such as the rise of CCAs, a decline in the overall number of IPOs until 2020, falling equity commissions, fewer institutional investors that invest in small issuers, a shift from active to passive investment strategies, an increase in reliance on in-house research and an increase in alternative data sources.

At this time, however, the data limitations and ongoing industry adaptations to MiFID II and other legislative and regulatory changes create obstacles to determining the extent to which research coverage of small issuers has declined in recent years and the causes of such decline. For example, money managers and broker-dealers continue to adapt their business models to accommodate MiFID II requirements, which are in flux.²¹⁰ In that context, the staff periodically discusses research coverage and availability with global regulators as well as industry participants, which provide the staff with an opportunity to continue to monitor research trends. Therefore, the staff recommends that the staff continue to monitor research trends, including research into small issuers, and consider what, if any, potential actions may be appropriate to recommend to increase the demand for, volume of, and quality of investment research into small issuers. As part of this evaluation, the staff recommends that the staff continue to engage with global regulators and industry participants to better understand any developments in the research marketplace.

²¹⁰ See EU Amendment, *supra* note 151; FCA Policy Statement, *supra* note 153.

VIII. Appendix

Table 1. Number of issuers covered per analyst firm

Year	Total Number of Issuers with Coverage	Average Issuers Covered per Analyst Firm	25th / 50th / 75th Percentile of Issuers Covered per Analyst Firm	Number of Analyst Firms	Number of Analysts ²¹¹	Average Number of Analysts per Analyst Firm
2016	4,264	120	4 / 16 / 107	325	3,817	11.7
2017	4,202	115	4 / 15 / 100	327	3,640	11.1
2018	4,227	117	5 / 17 / 93	312	3,547	11.4
2019	4,245	119	5 / 16 / 89	305	3,472	11.4
2020	4,113	110	4 / 16 / 78	314	3,420	10.9

²¹¹ The total number of analysts in IBES who cover exchange-listed stocks may be an undercount of the actual number of analysts employed by analyst firms because some smaller analyst firms may not submit estimates to IBES, and it is also likely in some cases that more than one analyst contributes to the work behind a set of estimates for a single stock even though IBES identifies only a single analyst, presumably the lead analyst, per estimate.

Table 2. Number, percentage, and market capitalization of issuers with exchange-listed stocks²¹²

Year		Count (%)	Mean Market Capitalization (\$millions)	Median Market Capitalization (\$millions)
2016	All Exchange-Listed Stocks	5171	\$5,263	\$595
	Stocks w/ Coverage	4264 (82.5%)	\$6,264	\$911
	Stocks w/o Coverage	907 (17.5%)	\$532	\$62
2017	All Exchange-Listed Stocks	5095	\$6,214	\$728
	Stocks w/ Coverage	4202 (82.5%)	\$7,412	\$1,106
	Stocks w/o Coverage	893 (17.5%)	\$547	\$73
2018	All Exchange-Listed Stocks	5120	\$6,739	\$777
	Stocks w/ Coverage	4227 (82.6%)	\$8,026	\$1,193
	Stocks w/o Coverage	893 (17.4%)	\$590	\$80
2019	All Exchange-Listed Stocks	5145	\$6,939	\$669
	Stocks w/ Coverage	4245 (82.5%)	\$8,304	\$1,064
	Stocks w/o Coverage	900 (17.5%)	\$438	\$78
2020	All Exchange-Listed Stocks	5348	\$7,266	\$601
	Stocks w/ Coverage	4113 (76.9%)	\$9,215	\$1,017
	Stocks w/o Coverage	1235 (23.1%)	\$721	\$139

²¹² The number of stocks represents the number of exchange-listed common stocks, REITs, foreign private issuers, foreign incorporated firms, and master limited partnerships available in CRSP. ETFs, closed-end funds, and commodity pools are excluded from this count. Data on analyst coverage is available in IBES. Issuers with multiple exchange-listed voting classes or issuers with multiple exchange-listed tracking stocks are considered in Table 2 calculations as a single stock with research coverage if one or more of such classes or tracking stocks has research coverage.

Table 3. Number and percentage of exchange-listed stocks by market capitalization of issuers²¹³ with average number of analyst firms providing coverage

Year	Number of Stocks (%)		Average Number of Analyst Firms Providing Coverage per Stock	
	Market Capitalization: \$0M - \$250M	Market Capitalization: \$250M+	Market Capitalization: \$0M - \$250M	Market Capitalization: \$250M+
2016	1830 (35.4%)	3336 (64.6%)	2.1	10.5
2017	1621 (31.9%)	3469 (68.2%)	1.9	9.9
2018	1598 (31.3%)	3514 (68.7%)	1.8	9.6
2019	1710 (33.3%)	3426 (66.7%)	2.0	9.6
2020	1851 (34.7%)	3487 (65.3%)	1.9	8.9

²¹³ Certain stocks do not have market capitalization data in CRSP. These stocks were not classified into either group.

Table 4a. Percent of exchange-listed stocks with analyst firm coverage by market capitalization of issuers

Year	Number of Stocks	Percentile Group by Market Capitalization									
		0 th to 10 th	10 th to 20 th	20 th to 30 th	30 th to 40 th	40 th to 50 th	50 th to 60 th	60 th to 70 th	70 th to 80 th	80 th to 90 th	90 th to 100 th
2016	5171	40%	56%	74%	83%	89%	96%	95%	97%	98%	98%
2017	5095	42%	55%	75%	80%	90%	94%	95%	96%	99%	98%
2018	5120	41%	61%	73%	79%	88%	94%	96%	98%	98%	98%
2019	5145	45%	61%	71%	76%	89%	94%	96%	98%	98%	99%
2020	5348	43%	59%	68%	67%	76%	84%	88%	94%	93%	98%

Table 4b. Average number of analyst firms covering exchange-listed stocks by market capitalization of issuers

Year	Number of Stocks	Percentile Group by Market Capitalization									
		0 th to 10 th	10 th to 20 th	20 th to 30 th	30 th to 40 th	40 th to 50 th	50 th to 60 th	60 th to 70 th	70 th to 80 th	80 th to 90 th	90 th to 100 th
2016	5171	0.9	1.7	2.8	4.0	4.8	6.6	8.3	11.2	13.5	21.3
2017	5095	1.0	1.7	2.8	3.8	4.8	6.2	8.3	10.2	13.7	21.2
2018	5120	0.9	1.7	2.7	3.4	4.6	6.0	8.1	10.1	13.1	21.0
2019	5145	1.0	1.8	2.7	3.3	4.7	5.9	8.1	9.7	12.9	20.5
2020	5348	1.0	1.8	2.5	3.1	4.0	5.0	6.7	8.9	12.1	19.8

Table 4c. Upper cutoffs for each market capitalization percentile group²¹⁴ for Tables 3a and 3b

Year	Percentile Group by Market Capitalization									
	0 to 10 th	10 th to 20 th	20 th to 30 th	30 th to 40 th	40 th to 50 th	50 th to 60 th	60 th to 70 th	70 th to 80 th	80 th to 90 th	90 th to 100 th
	Market Capitalization Upper Cutoffs for each Percentile Group (\$millions)									
2016	\$36	\$86	\$178	\$330	\$595	\$1,089	\$1,901	\$3,591	\$9,531	\$566,254
2017	\$40	\$104	\$220	\$416	\$728	\$1,282	\$2,277	\$4,238	\$11,065	\$784,145
2018	\$41	\$107	\$236	\$424	\$777	\$1,353	\$2,365	\$4,619	\$11,940	\$911,163
2019	\$34	\$93	\$207	\$372	\$669	\$1,243	\$2,271	\$4,554	\$12,203	\$1,011,709
2020	\$35	\$101	\$191	\$336	\$601	\$1,113	\$2,114	\$4,249	\$12,025	\$1,663,468

²¹⁴ Each percentile group contains issuers with market capitalization above the previous cutoff and at or below the current cutoff. For example, issuers within the 20th to 30th percentile group in 2020 have market capitalization above \$101M and at or below \$191M.