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Client Alert News Flash

Latham & Watkins Financial Regulatory Practice 26 October 2017 | Number 2233

MiFID II Research – Relief at Last?

US and EU authorities have finally moved to solve the cross-border issues arising from MiFID II rules on research unbundling.

Key Points:

- The US SEC has published three temporary "no action" letters, which are designed to facilitate compliance with the new MiFID II research provisions while preserving the existing US regulatory structure.
- Concurrently, the European Commission has published a set of FAQs, clarifying expectations of EU investment firms when they seek to use brokerage and research services from broker-dealers in non-EU countries.

Overview

On 26 October 2017, the SEC published a press release announcing the publication of three "no action" letters, offering relief for US broker-dealers looking to continue to provide research to EU investment firms once MiFID II comes into force on 3 January 2018.

The European Commission also published a short FAQ document, setting out its views on two specific issues concerning how EU investment firms may receive research from non-EU broker-dealers, whilst complying with their MiFID II obligations.

This follows months of discussions between the regulators either side of the Atlantic, as they have sought to resolve the incompatibilities between the existing US regulatory regime and the new MiFID II rules on research unbundling.

There is also a statement from the FCA, welcoming the above publications and offering some additional guidance of its own.

The issue arose out of unintended consequences created by the MiFID II rules on research unbundling. These require that EU asset managers pay separately for research and execution services. EU asset managers can either pay for research directly from their own funds, or from a client-funded research payment account (RPA).

Whilst EU broker-dealers are required by MiFID II to price their research and execution services separately, no such explicit obligation is imposed upon non-EU broker-dealers. However, as EU asset managers must pay for research separately, they have been requiring non-EU broker-dealers to price

their research separately, as otherwise those EU asset managers will be unable to meet the MiFID II obligations with which they are bound to comply.

This has caused particular issues in the US, where the receipt of separate payments for research by a broker-dealer leads to the loss of an exemption from additional regulation by the SEC as an investment adviser. Investment adviser status brings with it a number of burdensome regulatory obligations, including most significantly fiduciary duties. This left US broker-dealers with the unhappy choice of either being regulated as an investment adviser and taking on those obligations, or stopping sending research into the EU.

SEC no action letters

The first no action letter provides temporary relief for US broker-dealers, allowing them to receive direct payments (or payments through an RPA) from EU investment firms that are subject to MiFID II, without being considered an investment adviser. The relief will be provided for a period of 30 months from 3 January 2018.

The temporary nature of the measure is intended to provide the SEC with sufficient time to better understand the evolution of business practices post-MiFID II implementation. The SEC intends to monitor and assess the impact of the MiFID II research provisions, with a view to determining whether more tailored or different action (such as making new rules) is necessary or appropriate.

The second letter addresses the issue that US investment advisers will be putting in place different payment arrangements for different clients, given that EU asset managers will be paying for research separately and other clients will not. This relief permits investment advisers to 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.

The third letter provides relief for US money managers, allowing them to continue to rely on an existing safe harbour when paying broker-dealers for research and brokerage. The safe harbour addresses the manner in which a money manager can use client commissions to purchase brokerage and research services, without breaching its fiduciary duty. The relief allows money managers to operate within the safe harbour if they make payments for research to an executing broker-dealer out of client assets alongside payments for execution through the use of a MiFID II-compliant RPA, and the executing broker-dealer is legally obliged to pay for the research.

EU guidance

The European Commission's short FAQ document clarifies the Commission's position on two issues.

First, it explains that an EU asset manager (or its sub-adviser in a non-EU country) may pay a non-EU broker-dealer a single commission for research and execution services, provided that the payment attributable to research can be identified. The Commission also highlights that, for EU asset managers that have chosen to use the RPA option to pay for research, they must still comply with all of the RPA requirements, including maintaining a clear audit trail of payments made to research providers and being able at all times to identify the amount spent on research with a particular third country broker-dealer in relation to each client.

Second, it addresses the question of whether non-EU broker-dealers are required by MiFID II to separate out research charges. The Commission explains that it is the EU asset manager (or its third country sub-

adviser) that is responsible for ensuring compliance with the MiFID II research requirements. In the absence of a separate research invoice, the EU asset manager may need to consult with third parties, including the third country broker-dealer, to determine the charge attributable to the research provided. The Commission also emphasises that the supply of and charges for research must not be influenced or conditioned by levels of payment for execution services. Therefore, this confirms that non-EU broker-dealers are not required by MiFID II to separate out research charges, but in practice EU asset managers will need them to identify the cost.

FCA reaction

The FCA has also published a short statement, welcoming the publications by the SEC and the European Commission.

The FCA emphasises the need to keep investors' interests in focus, stating that it supports continued access by EU firms to research produced by US and other non-EU jurisdictions.

Interestingly, the FCA helpfully also highlights another way in which firms may achieve compliance with the MiFID II requirements, aside from following the routes opened up by the SEC and the European Commission. It states that "*arrangements in which a UK asset manager pays the EU entity of a broker for global research content, or research is circulated within a buy-side group, can also be an acceptable way of achieving this, provided that they do not influence the firm's order routing decisions, execution costs and ability to act in its clients' best interests*". However, there are likely to be unwelcome tax consequences for any brokers receiving payment in this manner; something which the SEC does not address.

Problem solved?

These publications are to be welcomed and it is positive to see that the authorities were able to reach an agreement and provide a way forward with some time to spare before 3 January 2018.

However, the relief to be granted is very narrow, only providing dispensation in situations where the US firm is dealing with an EU firm that is bound to comply with MiFID II, leaving no opportunity for US firms to decide to take a consistent approach by unbundling across the market.

It will be important to see how the new rules bed-in next year, in order to judge whether the regime is workable for firms in practice.

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