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MiFID II Research Unbundling — Crisis Averted?

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On Oct. 26, 2017, the U.S. Securities and Exchange Commission published a press release announcing the issuance of three "no-action" letters, offering relief for U.S. broker-dealers looking to continue to provide research to European Union asset managers once MiFID II comes into force on Jan. 3, 2018. The first, and most significant, of the three SEC no-action letters addresses the issue of whether U.S. broker-dealers will be subject to additional regulation as "investment advisers" if they receive separate payments from EU asset managers for the provision of research services. The second and third letters deal with ancillary issues arising from the MiFID II unbundling requirements and the potential for different clients to pay differing amounts for research.

Also on Oct. 26, 2017, the European Commission published FAQs setting out its views on two specific issues concerning how EU asset managers may continue to receive "bundled" research from non-EU broker-dealers without breaching the obligations imposed on them under MiFID II.

The Financial Conduct Authority joined in by publishing a statement welcoming the above measures and offering some additional guidance of its own.

These regulatory actions follow months of discussions on both sides of the Atlantic, as market participants pressed for a solution to resolve the incompatibilities between the existing U.S. regulatory regime and the new MiFID II rules on research unbundling. These rules require that EU asset managers pay separately for research and execution services. Research services may be paid by EU asset managers either directly from their own resources or from a client-funded research payment account (RPA).

Although EU broker-dealers are required by MiFID II to price their research and execution services separately, no such explicit obligation is imposed on non-EU broker-dealers. However, since EU asset managers must soon pay for research separately in order to comply with their MiFID II obligations, they have been requesting non-EU broker-dealers to accommodate them by separating out the research cost from the trade execution cost, which has traditionally been bundled together and paid as a single commission.

This request to split a bundled commission into a definable research charge separate and apart from the actual trade execution charge has caused particular issues in the U.S., where the receipt of "special compensation" for research by a broker-dealer potentially subjects the broker-dealer to additional regulation and oversight by the SEC as an investment adviser. Investment adviser status brings with it a number of burdensome regulatory obligations, including fiduciary duties. As a result, U.S. broker-dealers were faced with the unhappy choice of either being regulated as an investment adviser and taking on those additional obligations, or cutting off access to U.S. research by EU asset managers.

SEC Response

Investment Adviser Status

In the first of the three SEC no-action letters issued on Oct. 26, 2017, the staff of the SEC's Division of Investment Management states that it will not recommend the SEC take enforcement action against a U.S. broker-dealer (or a non-U.S. broker-dealer relying on the exemption from broker-dealer registration provided by SEC Rule 15a-6) that receives direct "hard dollar" payments (or payments through an RPA) from EU asset managers that are expressly subject to MiFID II, or from subadvisers to such entities that are contractually obligated to comply with MiFID II requirements, without complying with the provisions of the U.S. Investment Advisers Act of 1940 applicable to entities that fall within the definition of "investment adviser" under that act. The no-action relief was granted on a temporary basis and will expire 30 months following the Jan. 3, 2018, implementation date of the MiFID II unbundling requirements.

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 is necessary or appropriate.

Trade Aggregation Issues

The second no-action letter, which was also issued by the staff of the SEC's Division of Investment Management, provides that investment advisers may continue to aggregate client orders for purchases and sales of securities where (as a result of the MiFID II unbundling requirements) some clients may pay different amounts for research but all clients will continue to receive the same average price for the security and the same execution costs. The SEC states that this relief provides "clarity and consistency to investment advisers by permitting the continued aggregation of orders while addressing the differing arrangements regarding the payment for research that will be required by MiFID II."

Section 28(e) Safe Harbor

The third no-action letter was issued by the staff of the SEC's Division of Trading and Markets and permits continued reliance by a money manager on the safe harbor provided by Section 28(e) of the U.S. Securities Exchange Act of 1934. The no-action relief allows a money manager to continue to purchase research services from a broker-dealer by paying higher commissions for trade execution without breaching its fiduciary duty to obtain best execution for its clients, if the money manager makes payments for research to an executing broker-dealer out of client assets alongside payments for execution through the use of an RPA that conforms to the requirements for RPAs in MiFID II. The relief is only available if all other applicable conditions of Section 28(e) are met (including, e.g., that the research payments are for services eligible for the safe harbor and 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 client commission arrangement).

EU Guidance

The FAQs issued by the EC clarify the EC's position on two important issues.

First, the EC explains that an EU asset manager (or its subadviser 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. Therefore, unbundling is not required when receiving research and execution services from a non-EU broker-dealer, so long as the amount of the payment attributable to the research is separately identifiable. However, the EC guidance also provides that EU asset managers that have chosen to use the RPA option to pay for research 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 non-EU broker-dealer in relation to each client.

Second, the EC guidance addresses the question of whether non-EU broker-dealers are required by MiFID II to separate out research charges. The EC explains that it is the EU asset manager (or its non-EU subadviser) 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 non-EU broker-dealer, to determine the charge attributable to the research provided. The EC guidance also emphasizes that the supply of and charges for research must not be influenced or conditioned by levels of payment for execution services. Thus, the EC guidance confirms that non-EU broker-dealers are not required by MiFID II to separate out research charges, but in practice EU asset managers will likely seek their assistance in helping them assign an appropriate cost.

Somewhat ironically, it appears that the EC guidance actually renders the SEC action unnecessary and many have wondered why the EC did not issue its guidance sooner, thus avoiding the need for the SEC to issue the various no-action letters discussed above. However, we understand that the EC guidance came as a "package deal" with the SEC companion relief — i.e., the EC would not have issued its guidance if the SEC had not issued its no-action letters (and vice versa). Thus, this coordinated effort may be indicative of a new spirit of cooperation, or simply a case of one regulator being unwilling to jump before the other.

FCA Statement

The FCA statement, issued on the heels of the actions taken by the SEC and EC, emphasizes the need to keep investors' interests in focus and reiterates its support for continued access by EU firms to research produced by broker-dealers in the U.S. and in other non-EU jurisdictions.

Interestingly, the FCA statement also provides that "arrangements in which a U.K. 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." While this may provide a useful alternative route for compliance with the MiFID II requirements while avoiding the unintended regulatory impact on non-EU broker-dealers, this does not address possible transfer pricing issues and other potential tax and other internal complications arising from such an approach. Nonetheless, the statement certainly appears to signal a desire to help mitigate the unintended consequences on non-EU broker-dealers of the unbundling mandate.

Problem Solved?

The SEC, EC and FCA actions discussed above are to be welcomed and it is refreshing to see that these three key securities regulators have come together in a coordinated way to address an issue that threatened to significantly change the landscape for the provision of research on a cross-border basis. However, that the issue arose at all — and that it took so long for the regulatory authorities in the various jurisdictions to find a way forward — points to a much larger issue. The securities markets are truly global and regulators that attempt to address issues in an isolated fashion without assessing the multijurisdictional impact risk doing great harm to the investing public.

Moreover, while the SEC's action provides a temporary fix for the MiFID II unbundling problem, it does not provide a solution for non-EU based asset managers that now wish to follow their EU peers and pay U.S. broker-dealers separately for research services. In order to address this issue, and indeed to make the temporary relief relating to payments by EU asset managers permanent, it appears that a statutory change in the U.S. will be required. Such a change, frankly, would be a logical next step and would help clarify the differing roles of broker-dealers and investment advisers under the U.S. regulatory scheme. There appears to be no reason for SEC-registered broker-dealers to also be separately regulated by the SEC as investment advisers if the only trigger for such status is the provision of impersonal, broadly distributed research, which does not seek to address the specific needs or investment portfolio of a particular client. Subjecting broker-dealers to this additional layer of regulation based on whether they receive payment for such impersonal research in the form of "soft" or "hard" dollars simply elevates form over substance, adds to investor confusion and sacrifices pricing transparency.

If the unbundling issue has served to highlight the inefficiencies in the U.S. regulatory scheme and the need for greater cooperation across borders on matters that affect the securities markets, perhaps it was not so much a "problem" that needed solving, but rather may actually mark the first step toward more globally focused regulatory solutions.

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