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Client Alert Commentary

Latham & Watkins Financial Regulatory Practice November 18, 2019 | Number 2561

# SEC Extends Relief From MiFID II Research Unbundling Provisions

***The extension benefits market participants in the US seeking to comply with EU MiFID II research rules, but significant issues remain.***

**Key Points:**

- The no-action relief has been extended for three additional years from the date of the original expiration, to July 3, 2023.
- Absent the extended relief, US broker-dealers receiving designated payments for research from EU-based asset managers risked losing the benefit of an exemption from additional regulation by the SEC as an investment adviser under the Advisers Act.
- The relief, however, remains silent as to US broker-dealers that wish to unbundle research and execution charges for non-EU-based asset managers.

On November 4, 2019, the Division of Investment Management staff (Staff) of the US Securities and Exchange Commission (SEC) issued an extension (Extension) of no-action relief that it previously granted in response to issues arising from the European Union Markets in Financial Instruments Directive II (MiFID II) research unbundling provisions. The original no-action letter was issued on October 26, 2017, and scheduled to expire on July 3, 2020. It provided that US broker-dealers could receive designated payments for research services from EU asset managers that are subject to MiFID II rules without being required to be regulated as investment advisers under the US Investment Advisers Act of 1940 (Advisers Act) (the guidance also covered non-US broker-dealers relying on the registration exemption provided by SEC Rule 15a-6). As such, US broker-dealers could receive "hard dollar" payments (or payments through a research payment account (RPA)) from EU asset managers, including their sub-advisers to entities that are contractually obligated to comply with MiFID II requirements, without falling afoul of certain provisions of the Advisers Act.

As in 2017, absent the extended relief, firms receiving designated payments for research risked losing the benefit of an exemption from additional regulation by the SEC as an investment adviser under the Advisers Act (see MiFID II Research — Relief at Last?). While the Extension continues to provide a temporary fix to this problem, significant issues remain, and it still appears that a global, long-term solution will ultimately be required.

## Background

MiFID II took effect on January 3, 2018. Notably, it requires the unbundling of research costs from execution costs with the goal of preventing the use of trading commissions to pay for research — a practice viewed by EU regulatory authorities as a potential conflict of interest and an "unlawful inducement." Asset managers in the EU must therefore pay for research either: (i) directly from their own funds, *i.e.*, hard dollar payments; or (ii) from an RPA funded by clients (and subject to strict operational requirements). As a practical matter, EU asset managers can only comply with their own obligations under the rules by requiring that their research providers price their research and execution fees separately. MiFID II unbundling rules do not apply to non-EU firms providing research to EU asset managers as long as payments attributable to research can be identified and tracked on a clear audit trail, as the European Commission clarified in its 2017 Guidance on the implementation of MiFID II. However, EU asset managers may still request that non-EU research providers accommodate their MiFID II compliance requirements by unbundling research costs from trade execution costs.

For US broker-dealers, complying with requests to unbundle research costs is problematic because 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. Accordingly, the Extension continues to provide US broker-dealers the ability (albeit still only on a temporary basis) to accept hard dollar payments or payment through an RPA from EU asset managers (or their contractually-bound sub-advisers) without being deemed investment advisers subject to the Advisers Act.

In a footnote to the Extension, the Staff also confirms that a broker-dealer would not lose its exclusion from the definition of "investment adviser" under the Advisers Act if it accepts commissions through client commission arrangements (CCAs) entered into in compliance with Section 28(e) of the US Securities Exchange Act of 1934 even if (i) the money manager receiving research from the broker-dealer does not have a trading relationship with that broker-dealer; or (ii) the trades executed by the broker-dealer (where a trading relationship with the money manager does exist) do not relate to that broker-dealer's research.

As with the original no-action relief, however, the Extension does not offer any relief to US broker-dealers that wish to unbundle research and execution charges for non-EU-based asset managers, either to harmonize with their billing methodology for EU asset managers, or as a pragmatic business decision if non-EU-based asset managers prefer an unbundled invoice. Thus, without additional SEC relief or a statutory change, US broker-dealers that do decide to accept hard dollar payments for research or otherwise unbundle research costs from trading commissions still face the loss of the current exemption from additional regulation as investment advisers under the Advisers Act.

## MiFID II Impacts Continue to Evolve

The SEC had previously suggested that it might choose not to extend the relief if appropriate market-based solutions emerged. SEC Chairman Jay Clayton noted, however, that the no-action relief was extended due to uncertainty around evolving MiFID II impacts on business practices and supply and demand for research, as well as the potential for modification of the rules by EU Member States once they have fully evaluated the impact of the rules. The Extension will allow the SEC to continue to monitor and evaluate the evolving landscape while allowing market participants a wider array of discretion as to how research is provided and accessed.

The SEC's announcement was welcomed by the UK Financial Conduct Authority (FCA). The research landscape, both in the EU and globally, continues to develop, and European regulators have been actively assessing the impact of research unbundling. The FCA recently provided preliminary feedback on

its view of how the rules are working. The FCA, which was one of the key advocates for the introduction of research unbundling, believes that the rules are working well so far, although it acknowledges that valuation and pricing models are still evolving. The FCA plans to carry out further work in this area in the next few years. At the EU level, planned reviews of various elements of MiFID II are underway, with reports due next year. These reports will provide further insight into how the rules are operating across the EU, and whether there could be appetite for change.

## Next Steps

The Extension delays the expiration date of the original no-action letter to July 3, 2023. During this period, US broker-dealers unbundling research costs for EU asset managers in compliance with the MiFID II requirements can rest assured that the SEC will not consider such broker-dealers to be investment advisers under the Advisers Act. However, as noted above, the relief does not provide a solution for broker-dealers providing research to non-EU-based asset managers that now wish to follow their EU peers and pay such broker-dealers separately for research services.

The SEC indicated that it will continue to monitor the impact of MiFID II on US broker-dealers and investors in the interim, and will assess the need for additional guidance or regulatory action as needed.

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