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IN FOCUS

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The EU's MIFID II, Broker Research, and the SEC's No-Action Letters

Broker-dealers are firms that buy and sell stocks or other securities for their own accounts or on behalf of their customers, such as pension funds, mutual funds, and other asset management clients. Larger broker-dealers are also known as investment banks. A key role that broker-dealers play for their asset management clients is facilitating the execution of their securities trades. Certain broker-dealers called sell-side firms have equity research units charged with providing both them and their buy-side clients with comprehensive financial analysis on corporate issuers aimed at helping them and their clients decide whether to acquire, hold, or sell certain securities. While some asset managers depend on broker-dealers for the bulk of their equity research, others reportedly also use research from independent entities or produce supplementary in-house research. Academic literature has found that such broker-dealer research on public companies can benefit the liquidity of their stocks and can help investors monitor their management.

Debate exists about how broker-dealers should charge asset management clients for their equity research. Some argue that bundling these activities into one price can enable the broker-dealers to cross-subsidize their investment research on small- and medium-sized firms through payments they receive for research on larger firms. However, bundled pricing can be criticized for its lack of transparency and its potential for causing conflicts between asset managers and their clients to the latter's detriment. In addition, questions exist about whether broker-dealers who charge clients for equity research should comply with U.S. regulations for investment advisers.

This In Focus discusses U.S. and European Union (EU) regulations around how broker-dealers charge for investment research and the potential impact that EU regulations may have on U.S. entities when a Securities and Exchange Commission (SEC) no-action letter expires on July 3, 2023. Broker-dealers that need to comply with EU regulations may be subject to investment advisor regulations in the United States due to compliance with the EU regulations. It discusses how the SEC regulates broker-dealers, the EU's MIFID II 2018 amendments, the impact of these amendments in the United States, and the policy debate about how the SEC should react to these impacts.

U.S. SEC Regulation Background

In 1975, the SEC mandated that broker-dealers would negotiate their trade execution commissions instead of charging fixed commissions as they had done historically. The same year, on the heels of that reform, Congress enacted a "safe harbor" under Section 28(e) of the Securities and Exchange Act. The amendment gave legal protection to investment advisers running asset management firms from claims that they violated their fiduciary duties by using client commissions to pay higher commissions to buy investment research than they might have paid for trade execution services. It also gave some impetus to the eventual U.S. and EU norm: the bundled soft-dollar arrangements, which combine trading and research into one price.

Under the Securities and Exchange Act, domestic broker-dealers described in this In Focus must register with the SEC and are also registered with and regulated by the Financial Industry Regulatory Authority, a self-regulatory organization overseen by the SEC. They have historically been excluded from regulation under the Investment Advisers Act (Advisers Act), which regulates investment advisers who have at least $100 million in assets under management or who advise investment companies (such as mutual funds). The exclusion applies if any investment advice they provide is "solely incidental" to their business as brokers-dealers and they receive no "special compensation" for providing the advice. Separate payments for research can be considered "special compensation" under the Advisers Act, thus invalidating the exclusion. As a consequence, the firms would be required to register as investment advisers, a different regulatory regime than that for broker-dealers.

The EU's MIFID II and the 2018 Amendment

The EU's financial regulations are known as the Markets in Financial Instruments Directive II (MIFID II). Since January 2018, the new MIFID-II-based protocol generally requires separate payments for securities research and trade execution to broker-dealers from MIFID-regulated asset managers, known as *unbundled hard-dollar* arrangements. It generally banned EU-based investment advisers who head asset management firms (such as pension and mutual funds) from (1) compensating broker-dealers with a single trading commission for both stock portfolio research and facilitating their securities trades or (2) depositing a certain part of each securities trade commission (such as 2 cents a share) into an account with either the trade executing broker-dealer or a third party such as an independent research firm, called commission sharing arrangements. Both of these practices are known as *bundled soft-dollar* arrangements.

The Impact of MIFID II in the United States and the SEC's No-Action Letter

In 2017, anticipating MIFID II, the SEC staff issued an action letter recommending no enforcement (known as a

no-action letter) on the regulatory implications of MIFID II for U.S. broker-dealers. The letter said that the SEC would temporarily not enforce the requirement that U.S. broker-dealers in receipt of MIFID-II-compliant hard-dollar arrangements and RPA-based research payments from EU- and United Kingdom (UK)-based asset management firm advisers must register as advisers under the Advisers Act. Its aim was to give the SEC staff "sufficient time to better understand the evolution of business practices after the implementation of MIFID II."

In 2019, the letter's initial expiration date was extended to July 3, 2023, when it is set to expire. It has been reported that most U.S.-based broker-dealers are not affected by the no-action letter, because their asset management firm clients are not regulated by MIFID II. Thus, if the letter expires, those brokers would not be required to comply with the Advisers Act. However, various domestic broker-dealers such as Goldman Sachs, Morgan Stanley, JP Morgan, and Citigroup are globally connected and serve UK- and EU-based asset managers regulated under MIFID II. For such firms, the letter's expiration would require that they be subject to the Advisers Act. Some domestic broker-dealers, including Merrill Lynch, have formed new units registered under the Advisers Act that provide research services for hard-dollar arrangements as required by MIFID II. Some are dual registrants separately registered as both broker-dealers and SEC-registered investment advisers.

In the event of the expiration of the no-action letter, non-broker observers say that many U.S. broker-dealers currently impacted by MIFID II would likely (1) register as investment advisers, (2) redeploy research units to affiliates already registered as investment advisers, or (3) withhold research produced by their U.S.-based operations from their MIFID- and UK-regulated clients.

In early June 2023, SEC Chair Gary Gensler indicated that plans for the letter's expiration in July 2023 were still on course.

Policy Debate

Much of the public policy discussion surrounding the possible impact of the letter's expiration involves the prospect that SEC-registered broker-dealers will opt for Adviser Act registration and face transition costs.

The prospect of the July 2023 expiration has garnered mixed responses. Among others, the Securities Industry and Financial Market Association (SIFMA), the domestic broker-dealer trade group whose earlier concerns prompted the no-action letter, and the SEC Small Business Capital Formation Advisory Committee have advised that the SEC extend the expiration deadline. Others—including the Council of Institutional Investors, an institutional investor trade group; the Healthy Markets Association, an investor advocate; and the CFA Institute, a global group of investment professionals—support the expiration. Meanwhile, some groups—such as the American Securities Association, a trade group of regional financial services firms—support the SEC making the thrust of the no-action letter permanent. Both H.R. 2622, marked up by the House Financial Services Committee on May 24, 2023, and a provision in H.R. 2799, marked up by the same committee on April 26, 2023, would codify the no-action letter.

A criticism made by SIFMA and some others of the SEC letting the no-action letter expire is that subjecting broker-dealers to Adviser Act registration is incompatible with brokers' client trade execution disclosure and consent requirements in the context of the "high speed and fluid" trades that they often engage in. Another assertion is that the broker-dealers' "arm's length" relationships with their clients in providing generalized client investment research under the Securities and Exchange Act differs from the Advisers Act's fiduciary mandate requiring advisers to act in the best interests of their clients. In addition, both the EU and the UK are reassessing MIFID II's impact on smaller-sized firms, so some argue that the SEC should delay removing the no-action letter until these EU regulations are finalized.

Supporters of letting the SEC's letter expire argue that doing so may beneficially lead to more unbundled hard-dollar arrangements, leading to more transparency and growing asset manager interest in shopping separately for research and trade execution, stimulating a more competitive market. In addition, some observers note that while the costs of transitioning to advisory status would vary for each individual broker, overall, the cost may not be large or "insurmountable."

In 2023, Zhang and Jackson reviewed available research on the impact of MIFID II's commission unbundling. They noted that research generally showed that it had reduced the aggregate level of analyst coverage for large-sized public firms through reducing analyst redundancy but not with respect to the coverage of small- and medium-sized firms. They found that MIFID II had expanded both the quality and the impact of research analyst coverage, resulting in increased capital market efficiency. However, they also observed that the EU has responded to concerns that MIFID II had hurt research coverage for small- and medium-sized firms by permitting soft-dollar payments for research on firms with less than €1 billion ($1.072 billion) in market capitalization. Similarly, they noted that the EU is currently considering returning to allowing market capitalization below €10 billion ($10.720 billion), which reportedly constitutes about 95% of EU-listed firms.

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