The SEC Should Let Broker-Dealers Unbundle Research Costs

By James Brigagliano, Hardy Callcott and Erica Robertson

Law360 (June 11, 2019, 2:45 PM EDT) -- The U.S. Securities and Exchange Commission is considering important questions concerning the regulation of research services provided by U.S. broker-dealers. Paradoxically, the issues arise because of a directive from the European Parliament commonly known as MiFID II.[1] MiFID II requires European Union investment managers to unbundle research and execution costs, and will continue to impose this requirement for the foreseeable future.

Traditionally, U.S. money managers have received research as part of their commission arrangements with broker-dealers. Managers may pay in excess of the lowest possible commission for execution if they get fair value for brokerage and/or research under Section 28(e) of the Securities Exchange Act of 1934. Section 28(e) requires that the broker-dealer receiving commissions for "effecting" transactions must "provide" the brokerage or research services.

Research is defined very broadly under 28(e) — a person provides research services if he furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing or selling securities, and the availability of securities or purchasers or sellers of securities.

In July 2006, the SEC issued interpretive guidance on money managers' use of client commissions to pay for research services under the Section 28(e) "soft dollar" safe harbor. The commission interpreted Section 28(e) to permit money managers to use client commissions to pay for research produced by someone other than the executing broker-dealer in certain circumstances.

As stated in the 2006 release: "We recognize the benefit to investors of money managers being able to functionally separate trade execution from access to valuable research." To come within the Section 28(e) safe harbor, the credits must be accrued with a broker-dealer which had some role in effecting a securities trade.

MiFID II

On Jan. 1, 2018, the MiFID II rules became effective. That regime requires money managers to "unbundle" payments for execution from associated "inducements" which include research. Under the MiFID II directive, EU investment firms providing portfolio management or investment advice cannot accept fees, commissions or any benefits from third parties for providing services to clients.

The rationale is that such fees or benefits are inducements, and create conflicts of interest between a firm and its clients. The European Securities and Markets Authority recommended that, for investment research not to constitute an inducement, the investment firm must pay for the research directly with its own funds, or pay for research from a research payment account funded by specific charges to its clients.

Investment firms can no longer pass on broker commissions to their clients where the commissions include research costs. In MiFID II, EU regulators are seeking to promote transparency and to facilitate best execution.

U.S. Money Managers Are Requesting to Pay for Research With Hard Dollars

Numerous U.S. money managers are requesting that they be able to unbundle research from execution, and pay for research with hard dollars. In some cases, the managers are subject to MiFID II because of a

U.K. or other EU affiliate in their families, or because they subadvise an EU client; but in other cases they cannot make that representation.

The U.S. managers are not following a U.S. regulatory mandate, but are responding to their best execution obligations to clients. That, in turn, has raised the issue of whether U.S. broker-dealers can accept hard dollars for research without being deemed to have accepted "special compensation," and therefore needing to register as investment advisers.

The legal issue arises under Section 202(a)(11)(C) of the Investment Advisers Act. That provision excludes from the investment adviser definition "any broker or dealer that provides investment advice to clients but whose performance of such services is solely incidental to the conduct of its business as a broker or dealer and which receives no special compensation therefor."

When broker-dealers provide research as part of a "bundled" commission through soft dollar arrangements, that research is "incidental" to their brokerage business. Section 28(e) explicitly contemplates that broker-dealers will offer research to clients. If payments for research and execution of trades are unbundled, then questions arise about the nexus between the research and the trades.

In other contexts, the SEC has expressed support for managers directing research dollars independently of execution. The SEC's 2006 Soft Dollar Release endorses commission sharing arrangements that allow money managers to direct soft dollars earned at one broker-dealer to pay for research at another firm.[1] Several no-action letters extend that principle.[2]

Yet U.S. broker-dealers are in a quandary. They must reject the requests of their institutional clients to unbundle, or significantly restructure their businesses.

In response to SIFMA, the SEC issued a no-action letter[3] providing that for the first 30 months after the implementation of MiFID II (until July 3, 2020), a U.S. broker-dealer may accept payments from an investment manager that MiFID II requires to pay for investment research, without registering as an investment adviser. However, more recently, the SEC staff, citing "market solutions," have stated that it may be unnecessary to extend the no-action relief.[4] Without the no-action letter, there is a substantial risk that a broker-dealer offering research in return for hard dollar payments from an investment manager would be deemed to be accepting "special compensation," requiring it to register as an investment adviser.

The fact that many EU and U.S. managers are using the relief provided in the SIFMA no-action letter has led U.S.-only counterparts to join the chorus seeking the ability to unbundle.[5] Notably, state and local government pension plans have requested to unbundle research and execution costs.[6]

Some firms are using innovative ways to reach this result. For example, published reports indicate that two large U.S. managers, Capital Group and T. Rowe Price, are paying for research out of commission sharing arrangements funded by "soft dollars," so they know exactly how much the research costs, as permitted by an existing SEC no-action letter.[7]

However, the advisers then refund the costs of that research.[8] Of course, if an asset manager reimburses the funds for research purchased from broker-dealers, from an economic standpoint it is exactly the same as having the money manager pay broker-dealers for the research directly. These developments raise the question of whether the commission should hold that paying with hard dollars requires the research provider to register as an investment adviser, while allowing payments from CSAs followed with reimbursement by the manager is permissible for a broker-dealer.

In our view, unbundling is here to stay. The commission must now determine whether unbundled research must be provided by investment advisers, or whether broker-dealers may continue to provide the research services that their clients request.

Requiring Restructuring of Research Could Diminish Investor Protection

Unless the SEC provides relief, a broker-dealer would be forced to restructure in one of two ways. The broker-dealer either could set up a separate registered adviser affiliate, or dually register. Either approach would involve dislocation.

The former approach is simpler to achieve. If research is housed in an investment adviser, there would be no reason to assume the additional expense and complexity of broker-dealer regulation.[9] But this approach would undermine the investor protections provided by the current regulatory scheme for research, all of which applies only to broker-dealers.

The SEC and FINRA carefully constructed the regulatory response to the research analyst conflict of interest scandal in the early 2000s. To build that regulatory structure, FINRA adopted Rules 2241 and 2242, and required analysts and their supervisors to pass the Series 16, 86 and 87 qualification examinations. The SEC adopted Regulation Analyst Certification. That entire framework would become ineffective if the research function is pushed into investment advisers, because those rules are all premised on securities research being offered by broker-dealers, not by firms solely registered as investment advisers.

A firm could create a separate research adviser affiliate and register it as an investment adviser. The research adviser's analysts would cover companies and issue research reports, notes and market commentary. While the research adviser likely would not provide individualized advice about a client's individual positions or trades, its analysts would be available to speak with investors who pay for research; and these clients would be deemed clients of the research adviser.

The research adviser, as an independent affiliate, would not be subject to the comprehensive regulation of FINRA's conflicts rules or the SEC's Regulation Analyst Certification. Nor would the research adviser be subject to FINRA's qualification examination requirements.

In that scenario, a broker-dealer would not be required to supervise the research adviser. The broker-dealer could distribute its affiliate's research to its retail customers under FINRA Rule 2241(h). Moreover, Advisers Act provisions and rules regarding custody, wrap fees, best execution, aggregation of client orders, and principal trading and cross trades should not apply to the research adviser, because it will not hold customer accounts, nor trade for customers or on a proprietary basis.

The research adviser would have to establish its own compliance program under Rule 206(4)-7, and its own code of ethics under Rule 204A-1. However, no rule requires that these documents mirror the substantive requirements of the FINRA and SEC research rules. For institutional customers who wish to pay the research adviser directly, the research adviser would have to deliver a Form ADV, but the disclosure requirements of the Form ADV are not designed for an investment adviser that does not manage or advise customer accounts.

A dually-registered broker-dealer and investment adviser firm, or BD/IA, would have all of the regulatory requirements of a stand-alone registered investment adviser. Thus, the BD/IA would register with the SEC as an investment adviser. Client relationships with the BD/IA would need to be repapered. Any trading in the advisory accounts likely would be subject to principal trading and cross trade restrictions under the 1998 Section 206(3) Interpretation.

The BD/IA would be subject to the books and records, advertising and disclosure requirements under the Advisers Act. The BD/IA would need to disclose on its Form ADV the firm's potential conflicts of interests. Then, on a report-by-report basis, the broker-dealer would disclose all of the conflicts relevant to that report.

Harmony With Current Regulatory Scheme for Research Services

There are strong policy reasons why the SEC should not deem either hard or soft dollar payments for research to be special compensation. If the SEC deemed payments for research to trigger investment

adviser registration, so that firms had a regulatory incentive to move their research operations to investment adviser entities, it would render the existing SEC-approved FINRA scheme of research regulation largely ineffective.

Moreover, research coverage has already been diminished for smaller public companies over the past 15 years, because of regulatory burdens and other market developments.[10] The commission should not create another expensive obstacle for firms to navigate — the likely result of which would be less research, and less liquidity, for smaller public companies and their shareholders.

The FPA Decision Does Not Preclude Relief

We do not believe that the D.C. Circuit's opinion in Financial Planning Association v. SEC gives the SEC less latitude to deem hard dollars paid for research to be something other than special compensation.[11]

In the rulemaking leading to the FPA decision, the commission conceded the fee-based payments constituted special compensation, but it argued that it could exempt brokers receiving special compensation under the "catch-all" exemptive provision of Section 202(a)(11)(H). The D.C. Circuit disagreed, and held that the commission's position effectively rewrote the broker-dealer exception in Section 202(a)(11)(B) of the act by eliminating the special compensation provision.

However, the commission retains authority to define the scope of what constitutes special compensation under Section 202(a)(11)(B) itself, something it did not purport to do in FPA. Even if the SEC staff previously took a broad view of special compensation, the commission has the authority to update those interpretations in light of new market developments like MiFID II and the evolution of its experience and expert judgment.[12]

Here, the payments are limited to a purpose, research, which Section 28(e) expressly intends for broker-dealers to provide. The asset manager simply could direct commissions to the research providers it deems most valuable for its clients. This outcome promotes both transparency for the asset manager's activities and independence of research. There would be no added regulatory value in layering investment adviser regulation onto these payments, and there would be harm in removing the existing scheme of broker-dealer research regulation.

Conclusion

We believe the SEC can permit broker-dealers to "unbundle" the cost of research and the cost of execution for all clients, not just for clients subject to MiFID II. Both sound policy and precedent support that course.

The commission should clarify that hard dollars accepted by broker-dealers for research do not constitute "special compensation" that disqualifies broker-dealers from the exception to the definition of "investment adviser."[13] The commission has the tools to craft targeted relief to accomplish that legally well-founded and common-sense policy outcome.[14] To do otherwise would complicate and increase the costs of compliance, and more importantly, undermine investor protection.

James Brigagliano and W. Hardy Callcott are partners at Sidley Austin LLP. Brigagliano was formerly deputy director of the SEC's Division of Trading and Markets. Callcott was formerly assistant general counsel for market regulation in the SEC's Office of General Counsel.

Erica S. Robertson is a staff attorney at Sidley Austin.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the

Securities Exchange Act of 1934, Exchange Act Release No. 54165, July 18, 2006, available at https://www.sec.gov/rules/interp/2006/34-54165.pdf.

[2] See, e.g., Investment Company Institute, SEC Staff No-Action Letter, Oct. 20, 2017, available at https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm; SIFMA No-Action Response, infra note 3; BNY Converge-Ex LLC, SEC Staff No-Action Letter, Sept. 10, 2010, available at https://www.sec.gov/divisions/investment/noaction/2010/bnyconvergex092110.pdf.

[3] See Securities Industry and Financial Markets Association, SEC Staff No-Action Letter, Oct. 26, 2017, available at https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm.

[4] See, e.g., Dalia Blass, Director, Division of Investment Management, Keynote Address: ICI Mutual Funds and Investment Management Conference (March 18, 2019), available at https://www.sec.gov/news/speech/speech-blass-031819.

[5] Siobhan Riding, Invesco and Wellington Eye Global Adoption of Mifid II, Financial Times, March 4, 2019, available at https://www.ft.com/content/075382ef-6c58-3b21-9010-63aa8e013d70.

[6] See, e.g., Letter from Amy C. McGarrity, Chief Investment Officer, Colorado Public Employees' Retirement Association, to Hon. Clayton, Jan. 31, 2019, available at https://www.sec.gov/comments/mifidii/cll5-4919382-178351.pdf (requesting on behalf of PERA, an asset owner responsible for retirement and other benefits to more than 600,000 Colorado public employees, the unbundling of research services from execution); Letter from David Villa, Executive Director/Chief Investment Officer, State of Wisconsin Investment Board, to Hon. Clayton, Jan. 31, 2019, available at https://www.sec.gov/comments/mifidii/cll5-4864096-177346.pdf (requesting on behalf of SWIB, a public pension responsible for managing the Wisconsin Retirement System, the SEC allow soft dollar and hard dollar payments to broker-dealers).

[7] See, e.g., John D'Antona, WBR ELS: T Rowe's Williams Talks SEC and MiFID II, Markets Media, Dec. 6, 2018, available at https://www.marketsmedia.com/wbr-els-t-rowes-williams-talks-sec-and-mifid-ii/; Beagan Volz, Cap Group Stops Charging Investors for Third-Party Research, Ignites, Jan. 3, 2019, available at http://ignites.com/c/2168123/260583/group_stops_charging_investors_third_party_research?referrer_module=article&module_order=0.

[8] Volz, Cap Group Stops Charging Investors for Third-Party Research, Ignites, Jan. 3, 2019, available at http://ignites.com/c/2168123/260583/group_stops_charging_investors_third_party_research?referrer_module=article&module_order=0; Wall Street braces for MiFID-style rules descending on U.S., Pensions & Investments, Jan. 24, 2019, available at https://www.pionline.com/article/20190124/ONLINE/190129924/wall-street-braces-for-mifid-style-rules-descending-on-us.

[9] Moreover, setting up the research function in a separate legal entity likely would avoid difficult questions about the application of the principal trading restrictions of Section 206(3) that would exist if the research function is contained in a dually-registered firm that also receives commissions for executing securities transactions resulting from the research. See Interpretation, Application of Section 206(3) of the Investment Advisers Act of 1940, Investment Adviser Act Release No. 1732, July 17, 1998, available at https://www.sec.gov/rules/interp/ia-1732.htm.

[10] See, e.g., Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules, December 2005, available at https://www.sec.gov/rules/sro/finra/2014/34-73623-ex3b.pdf, at 25-26; Paul Clarke, Investment Bank Research Teams Suffer Deepest Job Cuts, Financial News, Feb. 27, 2019, available at https://www.fnlondon.com/articles/investment-bank-research-teams-bear-the-brunt-of-job-cuts-20190227.

[11] Financial Planning Association v. SEC, 482 F.3d 481 (D.C. Cir. 2007).

[12] See SEC Press Release: SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions, Oct. 27, 2017, available at https://www.sec.gov/news/press-release/2018-301 (monitoring and assessing the impact of MiFID II on broker-dealers and investment advisers).

[13] See Interpretation, Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Investment Adviser Act Release No. 5249, June 5, 2019, available at https://www.sec.gov/rules/interp/2019/ia-5249.pdf(noting that the commission's interpretation of Section 28(e) of the Exchange Act is still acceptable but not explicitly addressing other client commission arrangements in light of MiFID II, and whether a broker-dealer accepting hard dollars for research constitutes special compensation).

[14] Indeed, to the extent that relief is provided through a no-action letter, it is not even subject to challenge because it is not "final agency action." See e.g., Heckler v. Chaney, 470 U.S. 821, 832 (1985) (stating "an agency's decision not to take enforcement action should be presumed immune from judicial review"); Soundboard Association v. Federal Trade Commission, 888 F.3d 1261 (D.C. Cir. 2018) (holding informal staff letters do not constitute final agency action and as such are not eligible for judicial review).

Article Link: https://www.law360.com/articles/1166455/the-sec-should-let-broker-dealers-unbundle-research-costs