Update on MiFID II Unbundling

SEC No-Action Comment Letter[1]

Background

In January 2018, the Markets in Financial Instruments Directive II (MiFID II) and related rules and regulations were implemented, and investment managers subject to MiFID II were required to unbundle payments for research from payments for trade execution.

As a result of the MiFID II requirements, U.S. broker-dealers that provide research services to investment managers subject to MiFID II are now receiving separate payments for those research services. This, however, is problematic because the receipt of these payments may subject broker-dealers that are providing research services to be deemed as receiving compensation that is not incidental to the provision of brokerage services and thus subject these broker-dealers to registration under the Investment Advisers Act of 1940, which has different requirements and a regulatory regime that would apply in addition to the regulatory oversight of the broker-dealer by the SEC and FINRA.

Market participants raised concerns over the requirement that registered broker-dealers accepting unbundled payments for research services used by MiFID II managers would be subject to regulation as investment advisers under the Investment Advisers Act of 1940. In October 2017, the SEC responded to these concerns with the issuance of a no-action letter that it subsequently extended in November 2019 (collectively referred to herein as the "no-action letter").[2] In the no-action letter, the SEC advised that it would not recommend enforcement action for broker-dealers accepting cash payments for research from investment managers who chose to pay for research from the managers' own money as opposed to client commissions (as a result of MiFID II). The no-action relief is set to expire on **July 3, 2023,** and the SEC has announced that it will not be delaying the expiration or extending the no-action relief.

What is the impact?

Brokers in the U.S. have relied on the no-action letter to accept cash payments from buy side managers who are subject to MiFID II rules.

While most global research is paid via trading commissions, several European, global and U.S. asset managers pay research in cash or directly from fund assets post MiFID. Most European managers did so in order not to trigger the budgeting and reporting requirements under MiFID, while U.S. only managers mostly did so at the request of EU asset owners who required the U.S. manager to pay for research directly.

Due to the possible expiration of the no-action letter, buy side firms were anticipating that U.S. brokers would register as investment advisors, which would allow them to continue to accept cash payments. Because of certain challenges, including the onerous regulatory requirements and

[1] The information provided in this summary does not, and is not intended to, constitute legal advice; instead, all information, content, and materials are for general informational purposes only. Firms should not act or refrain from acting based on information contained herein without first seeking legal advice from counsel.

[2] https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm and https://www.sec.gov/investment/sifma-110419.

burdens associated with registering, brokers have declined to do so.

Recently, a proposal was brought before Congress that would require the SEC to extend the no-action relief for six months and to conduct a study to determine whether to make the relief permanent.[3] While the legislation has broad bi-partisan support in the House Financial Services Committee, it remains to be seen if it would win support in a floor vote before the full House of Representatives. And to become law, it would need to be taken up by the Senate, which is unlikely to happen before the July 3 expiration. Even if the odds of the legislation passing are slim, the broadly bipartisan bill could put pressure on the SEC to act on its own to extend the relief, but we remain concerned that the SEC will allow the relief to expire in July.

How do buy side firms know if and how they are impacted by the expiration of the no-action relief and what should they do to prepare?

Because we do not have clear direction from regulators on what the industry should do post July, there is much confusion and speculation both from the buy side and sell side community. In speaking with our clients, it is clear there are numerous scenarios and client structures that impact how buy side firms are affected and there are various factors they should consider.

The following is a series of questions and answers from client discussions that highlight common concerns along with things to consider.

QUESTION 1

I am a U.S. domiciled asset manager with no registered entities in Europe. All of my asset owner clients are domiciled in the U.S., and I currently consume and pay for research both inside and outside of the U.S., including in the European Union either through bundled trades where the executing brokers either provides proprietary research or arranges to pay for third party research through Commission Sharing Agreement ("CSA") arrangements.

Does the SEC no-action letter impact me and what are my options to pay for research after July 3?

There is no direct impact to you from the expiration of the SEC no-action letter. Under the current safe harbor set out in Section 28 of the Securities Exchange Act of 1934 and applicable guidance, you can obtain research, whether proprietary research produced by the executing broker or third-party research that the executing broker pays for from a CSA account funded by the executing broker with trading commissions.

QUESTION 2

If I am a U.S. registered asset manager, can I pay for research from P&L or the fund's assets?

Yes, as an asset manager you can pay for research in any form permitted between you and your

[3] https://financialservices.house.gov/uploadedfiles/gottheimer_ans.pdf

client's disclosure documents. However, your choice of the research provider may be more limited. U.S. broker-dealers providing research can only receive payments provided by executing brokers in connection with trades they execute on your behalf. Otherwise, a U.S. broker providing research unrelated to trades must register as investment advisor. As a result, there may be fewer broker-dealers who are able to provide you with research.

QUESTION 3

I am a U.S. registered asset manager with a global structure and have an FCA registered entity that must comply with MIFID II rules. How does the possible no-action-letter expiration impact me?

Your direct impact will depend on your global structure. Do you run one global research evaluation process and one global payment method, or do you separate regional processes and follow local regulatory requirements in each region?

- If you currently pay for research in the U.S. through a CSA, which is consistent with current SEC guidance, and in Europe through an RPA funded with trading commissions, which is consistent with MiFID II, you can continue to pay for research as you have been because the no-action letter's expiration should not impact you.
- If you currently pay for research in the U.S. by CSA and in Europe by P&L and only pay EU brokers from P&L, then you can continue as you have been since P&L payments in Europe are acceptable under MiFID II.
- If you currently pay for research in Europe by P&L and pay U.S. brokers from P&L, the U.S. brokers who were able to accept the P&L payment by relying on the SEC no-action letter will no longer be able to do so.

QUESTION 4

If the broker will no longer accept my payment from P&L, how do I pay them post July 3rd?

If you consume research from a registered investment advisor (RIA)/ Independent Research Provider (IRP) or a broker registered as an RIA, you can continue to pay them for research through P&L or direct fund assets. Non-RIA brokers in the U.S. will not be able to accept payment for research from P&L and will need to find a commission method for payment. In the U.S, you would pay for research from a CSA; in the EU region, you would pay for research from an RPA funded with dealing commissions.

QUESTION 5

Can I pay the U.S. broker in Europe where they can accept a P&L payment?

Possibly, but this would require the U.S. broker to have a presence in the EU and be able to accept the payment in EU due to a global arrangement with the buy side firm. However, this may not be possible for several reasons, including that the broker may not have a presence in EU. Such a presence could not be in the form of a branch of the U.S. broker. Rather, it would need to be an affiliate of the broker-dealer registered and active in the EU. There could be differences between where the research is consumed and where the research touch point for the broker is domiciled and registered.

QUESTION 6

We have told our clients that we would directly pay for research, and we cannot go back and change that now. How do we solve for that if we cannot pay the broker in EU?

For research that you cannot purchase through an EU affiliate, you can use a commission-funded method, such as an RPA or CSA, to pay for research and reimbursing your client, either through management fees or directly to the custodial account, may offer a good solution.

QUESTION 7

I am a U.S.-registered asset manager with no EU offices and no direct MiFID obligation, but I have EU asset owner clients and I also sub-advise for an EU manager who is subject to MIFID. To comply with my client and sub-advisor request to follow MiFID, we have been paying for their portion of research from P&L to U.S. brokers. The brokers have accepted our cash payment but are now telling us they will no longer be able to do so when the no-action letter expires. What are my options to pay the U.S. broker for my EU clients post July 3rd?

If the U.S. brokers that you want to pay are not registered as RIAs, you will have to now pay them from a CSA that is funded by trading commissions. If you wish to absorb the cost for those clients, you could reimburse them for the attributable cost of research.

QUESTION 8

Do I have to reimburse my client because of MiFID or the expiration of the no-action letter?

As a U.S. registered investment advisor, you must follow U.S. rules governing investment advisors. If you decide to pay for research for EU clients from P&L, it is a business decision and not a regulatory obligation. However, the U.S. broker cannot accept the P&L payment unless it also registered as an investment adviser.

QUESTION 9

Can I fund a CSA account with cash from management company funds to cover research cost of EU clients we have agreed to pay for?

No, only agency and riskless principal trading commissions from securities transactions can be used to fund a U.S. CSA account.

QUESTION 10

If I have clients that I agreed to pay research for directly as a U.S. buy side firm, can I have

my broker break up a block trade so that certain shares have a research tack on in addition to the execution rate and other shares of the same block trade with only an execution commission charged?

No, under U.S. aggregation rules, the full block would need to have the same average price and commission amount. The full trade would be executed with a research tack on.

QUESTION 11

If I have an affiliate office in Canada or APAC and wish to pay U.S. brokers from an affiliate through P&L, can I do so?

Yes, as an asset manager you can pay research in any form allowed between you and you client's disclosure document. However, if the U.S. broker is not registered as an RIA, the broker will not be able to accept the P&L payment.

QUESTION 12

I am a U.S. buy side firm and I pay for research through trading commissions. Do I need to trade directly with the same broker that I consume research from in order pay for the research?

No, SEC guidance makes it clear that you can pay for research from a CSA and the CSA does not need to be funded with trading executed with the same broker providing the research.[4] You should trade where you receive best execution to fund the CSA and then use those CSA funds to pay for research from any eligible third-party research provider.

QUESTION 13

I am an EU/UK domiciled asset manager that only consumes and pays for research from EU research firms. Does the expiration of the SEC no-action letter impact me and what are my options to pay for research?

Since you do not purchase research from U.S. domiciled brokers, the expiration of the SEC no--action letter will have no direct impact to how you consume and pay for research.

QUESTION 14

I am a U.S. manager and have been told if I trade in Europe, I am subject to MiFID unbundling rules.

A U.S. asset manager can trade either a direct bundled trade with a research broker or an unbundled CSA trade to fund a U.S. managed CSA account with trades executed in Europe. They are not subject to MiFID unbundling rules.

[4] *Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Release No. 54165; 71 CFR 41978 (July 24, 2006) available here.

QUESTION 15

I am an EU/UK domiciled asset manager and I consume research from U.S. research providers. How does the no-action letter expiration impact my firm?

Your impact will depend on several factors including the funding method you use and the types and domiciles of the broker(s) from which you consume research.

- If you consume research from an RIA/IRP or a broker registered as an RIA, you can pay for research through direct P&L, direct client fund assets or dealing commissions (RPA from trading).
- If you consume research from U.S. brokers who are not registered as an RIA, and the no-action letter expires, they will only be able to accept research payments funded with trading commissions. You would not be able to pay non-RIA brokers with P&L nor through direct charge RPA funded accounts. The U.S. broker can only accept payment from an RPA funded with trading commissions. Virtu's understanding based on discussions with the IM staff of the SEC is that per the AMG no-action letter from the SEC dated October 26, 2017,[5] if an RPA is funded by trading commissions and the payments are in conformity with previous SEC guidance on reliance on Section 28(e), the RPA funds can be used to pay a U.S. broker for research.

QUESTION 16

Do MIFID II rules require that a buy side firm pay for research through a P&L cash payment?

No, under MiFID rules, ESMA gave buy side firms a few options, each with different disclosure requirements. The following are options under MiFID:

- RPA funded with trading commissions;
- RPA funded with cash from direct client funding; or
- Direct asset manager P&L.

Note: An RPA can only be funded through dealing (trading) commissions or direct charge to the funds and not through asset manager cash contributions. P&L funds are not held in an RPA. The funding method that buy side managers use depends on many factors; most notably, whether they can afford to absorb the cost of the research directly.

QUESTION 17

Do buy side firms prefer to pay for research from P&L?

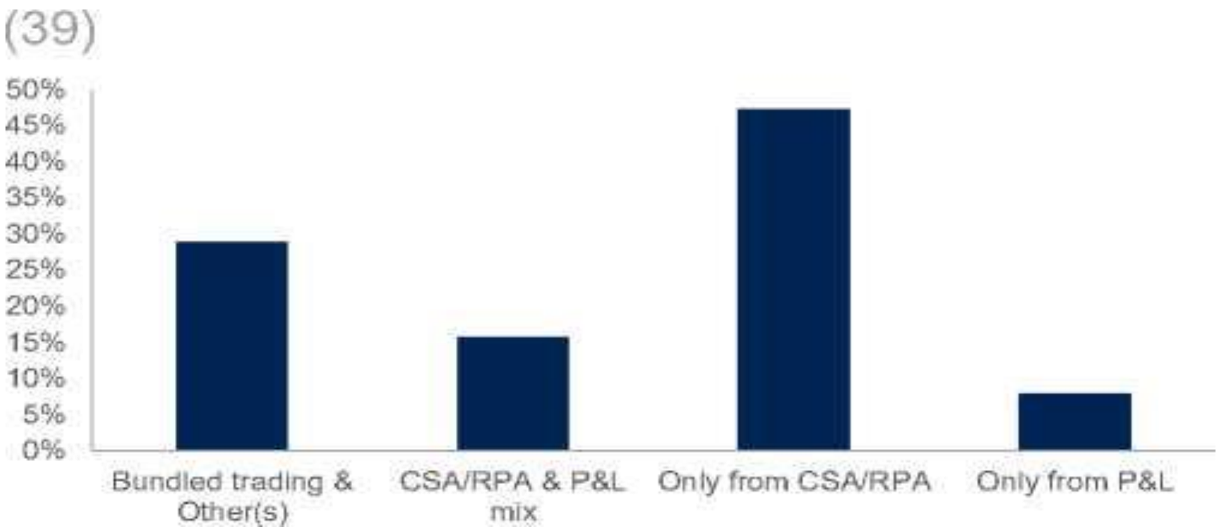
While many buy side firms in the EU pay for research from P&L, our research indicates that some EU managers pay for research from client funds and only a handful of U.S. and global asset managers pay research from P&L – and of those that do, most only do so for their EU MiFID

[5] https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf

regulated teams. The vast majority of U.S, Canadian and APAC buy side managers pay for research through trading commissions.

In a recent buy side survey, we asked the following question and received the following responses:

If the SEC No Action letter expires in July 2023, how will your firm pay for US broker research?



Marketplace participants can debate whether the SEC should extend the no-action letter or let it expire. However, for buy side firms, there remains confusion as to whether they are impacted if the relief is not extended and to what extent. If a buy side firm is impacted, it must explore alternative funding options and/or ascertain if the research broker has an office in the EU and can accept payment for research to the EU office.

Many buy side firms are creating lists of brokers who can provide research from the EU, which includes independent research providers and/or those who have registered as investment advisors. This way a manager will know which firms they can continue to pay with the direct charge method or P&L if they choose to or need to.

U.S. sell side brokers that are not registered as RIAs have begun notifying buy side clients that they will need to arrange alternative funding methods for research payments post-July; specifically, that only payments via trading commissions will be acceptable.

Concerns have been raised about whether RPAs funded with commissions are an acceptable method for payment for research to U.S. brokers. Based on Virtu's discussions with SEC staff, our understanding is that an RPA account funded with trading commissions may be used to pay for eligible research where the traditional requirements of the safe harbor are met.

Conclusion

In summary, large asset managers and sell side firms may be able to absorb the cost of research and additional cost to produce research. Many EU buy side firms are already planning to evaluate the brokers that cannot accept a P&L payment in the U.S. and possibly cease working with them. This impacts more than just EU buy side firms' ability to buy U.S. research – if the U.S. brokers find it too costly and burdensome to register as an RIA and/or cannot operate because of lost revenue, it will drive consolidation among research providers and closure of some smaller BDs whom the buy side rely upon to generate alpha. Most small and mid-sized asset managers and sell side brokers may not be able to absorb the cost of research or the added regulatory and operational costs required to continue providing research post-July 3rd. Ultimately, if a permanent fix is not found, the most negatively impacted will be the small retail investor.

Virtu does not directly produce research and has no bias to how buy side firms pay for research. As a practitioner that assists buy side clients navigate regulatory requirements and find workflow solutions, our goal is to guide our clients so they can access the research they want by providing them with workflows and tools to pay their research providers.

To hear how Virtu can help you navigate upcoming changes, please reach out to clientsrv@virtu.com or info@virtu.com.

Virtu Commission Management Team