sifma
Invested in America

Need for Continued MiFID II Relief:
Overview of Key Issues and Challenges under the Advisers Act
November 15, 2022

I. Overview

In January 2018, the Markets in Financial Instruments Directive II ("MiFID II") and related rules and regulations[1] were implemented, and investment managers subject to MiFID II (which includes both EU- and UK-based investment managers *and* U.S.-based investment managers that manage certain EU and UK accounts (collectively, "MiFID II Managers")) became required to separate, or "unbundle," payments for "research", as broadly defined under MiFID II and further described below ("Research Services"),[2] from payments for trade execution. To address concerns that registered broker-dealers accepting such required unbundled payments for Research Services consumed by the MiFID II Managers would subject these broker-dealers to regulation as investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act"), the staff of the Division of Investment Management ("IM") of the Securities and Exchange Commission ("SEC") issued a no-action letter in October 2017 to the Securities Industry and Financial Markets Association ("SIFMA") (the "SIFMA NAL").[3] The SIFMA NAL, which is scheduled to expire on July 3, 2023, has been critical in preserving the market for investment research by providing relief from the conflicts between U.S. and international laws that have impacted research providers and investment managers since the implementation of MiFID II.

In furtherance of our earlier meeting with the staff, and at the staff's invitation, we are writing to explain in more detail why firms' moving their research businesses to an investment adviser does not solve the issues created by MiFID II for many SIFMA members and why an expiration of the SIFMA NAL could significantly damage the market for, and some investment managers' access to, Research Services. Investment managers rely on a robust and diverse offering of investment research to fully inform their decision-making processes and to support the performance of their fiduciary duties to clients. Investment research also plays a critical role in the efficiency of the markets. In light of these considerations, we believe that it is in the best interest of investors and the markets for the SEC to work with the industry to devise a workable long-term solution to the issues and challenges created by MiFID II, and we have outlined three potential paths forward below. However, given that a permanent solution may not be achievable by the scheduled expiration of the SIFMA NAL on July 3, 2023, we believe that an extension of the letter is warranted to prevent a significant disruption to the market for investment research and access to investment research. We urge the staff to take action as soon as possible because uncertainties on the matter are already unsettling arrangements between MiFID II Managers and U.S. brokers, as MiFID II Managers are scrambling to evaluate if they will be cut off from important U.S. broker Research Services.

II. The Broker-Dealer Research Business Model Is Incompatible with Investment Adviser Registration

The business models of research providers vary, but a large portion of research is currently provided by broker-dealers that provide a suite of services to investment managers that may constitute "research" under the broad definition in MiFID II regulations[4]—including (1) written research reports and models produced by the broker-dealers' independent research departments ("Published Research"), (2) sales and trading commentary and other bespoke trade advisory services (*e.g.*, alpha capture, trading ideas, bespoke analysis) ("Sales and Trading Content"), and (3) interactions with research analysts, either with or without the participation of sales and trading personnel (together, "Research Services"). In addition to these Research Services, these broker-dealers typically also provide traditional sales and trading brokerage

services to the same managers or their end clients. The SIFMA NAL, which allowed broker-dealers to accept hard-dollar payments from MiFID II Managers for Research Services without being deemed investment advisers, was necessary because many of the requirements of the Advisers Act are fundamentally incompatible with how these research and sales and trading services are typically provided to investment managers.

Although some firms have reportedly moved part of their Research Services to a registered investment adviser,[5] we understand that this generally has been limited to such firms' Published Research services and, in some cases, related interactions with research analysts producing the Published Research, or has been undertaken by firms that lack active capital markets and sales and trading businesses, which are the source of many of the conflicts with the Advisers Act. Based on SIFMA's internal discussions with some of those firms, such firms continue to rely on the SIFMA NAL with respect to their Sales and Trading Content, and they would face the same challenges as other firms were the relief in the SIFMA NAL to expire and they had to consider moving their Sales and Trading Content services to an affiliated investment adviser. More critically, most large broker-dealers have not moved their Research Services into an investment adviser to accept hard-dollar payments because they have struggled with how to do so without significantly limiting the services that they have traditionally provided to investment managers. SIFMA's members in particular have spent an enormous amount of time examining how to provide services that may constitute research under the MiFID II regulations through an investment adviser, including Sales and Trading Content and related interactions, and a number have concluded that it would require significant and potentially detrimental changes to how they service investment managers and their clients and would pose numerous conflicts and challenges. We detail these conflicts and challenges below.

Section 206(3)

First, because of the often bespoke nature of Research Services that are expected by investment managers and provided by broker-dealers, it would be very challenging for firms to ensure that the advice provided as part of their Research Services is curtailed or limited so as to avoid the application of the Advisers Act restrictions on agency and principal trading in Section 206(3),[6] including through reliance on Rule 206(3)-1[7] (as discussed further below). The application of Section 206(3) is of particular concern given its prohibition on engaging in principal transactions with a client without trade-by-trade disclosure and consent, the limits of exceptions to this prohibition, and practical considerations given the fluidity and speed of trades with investment managers and their clients. These concerns exist regardless of whether a broker-dealer provides Research Services through an affiliated investment adviser or a separate research advisory department because the SEC has stated that it will apply Section 206(3) "not only to principal and agency transactions engaged in or effected by any adviser, but also to *certain situations in which an adviser causes a client to enter into a principal or agency transaction* that is effected by a broker-dealer that controls, is controlled by, or is under common control with, the adviser."[8] This raises significant questions for a broker-dealer evaluating the feasibility of moving its Research Services to an investment adviser, as such a move could significantly limit the activities of, and thus jeopardize, its sales and trading business.

While some research providers that are registered as investment advisers might seek to address concerns about Section 206(3) by relying on Rule 206(3)-1, that exception is limited to, in relevant part, "written materials or oral statements" that do not "purport to meet the objectives or needs of specific individuals or accounts." The precise scope of the exemption in Rule 206(3)-1 and its availability to affiliated broker-dealers remain unclear. Although Published Research should meet the Rule 206(3)-1 criteria, it is debatable whether research analysts' oral discussions with investment managers, which could focus on how to apply their Published Research views to the specific circumstances of the investment manager or one or more of their clients, would always fit within this safe harbor. Additionally, research analysts are often asked to provide bespoke research to investment managers using manager-selected criteria, and this activity would seem to stray even further from the Rule 206(3)-1 safe harbor, especially if

the investment manager then uses the bespoke analysis to place an order (something that would be very hard for a broker-dealer's sales and trading business to ascertain). This concern is even greater for discussions around Sales and Trading Content, which are even more likely to be tailored to the specific needs of an investment manager or its clients when generating potential trade ideas.

Fiduciary Obligations under the Advisers Act

Second, although broker-dealers are subject to extensive obligations when providing Research Services to brokerage clients, they are not treated as fiduciaries based on the same common-law principles that underpin the Advisers Act. In part, this is because the SEC has long understood that the provision of research by broker-dealers is a key way of soliciting securities transactions.[9] These common-law principles inform SEC and SEC staff interpretations of the Advisers Act and generally look to the exercise of investment discretion as the litmus test for fiduciary status of broker-dealers.[10] For example, broker-dealers providing Research Services in the institutional marketplace do not typically agree to provide investment managers with continuous investment advice and account monitoring, which the SEC in 2019 determined involves conduct not solely incidental to their primary business of effecting securities transactions.[11] Additionally, and more generally, applying the general fiduciary requirements of the Advisers Act to relationships between broker-dealer research providers and investment managers or their clients would be fundamentally inconsistent with the nature of broker-dealers' primary business of effecting securities transactions and the relationships between those broker-dealers and investment managers.

When investment managers receive research from broker-dealers, they do not do so with the expectation that such content is limited to ideas that are in the best interests of the investment manager and its clients. Like the SEC, investment managers understand that Research Services are typically provided as a means to solicit securities transactions. Typically, investment managers waive the application of the broker-dealer's customer-specific suitability obligations under FINRA Rule 2111 and represent that they are capable of independently evaluating any investment advice that they receive from the broker-dealer and will exercise independent judgment with respect to any such advice. Broker-dealers do not currently collect information from investment managers or their clients to comply with fiduciary standards. Investment managers may have hundreds or thousands of end-clients with different investment needs and objectives and that pursue many different and conflicting investment strategies. It could be unduly burdensome, if not impossible, for a broker-dealer research provider to tailor its Research Services to the many different investment managers to whom it provides services. At best, a broker-dealer research provider would be subjecting itself to significant risk in undertaking those obligations, and most firms have been unwilling to take on that level of risk. Additionally, and perhaps more importantly, we believe that the vast majority of investment managers *do not want* their research providers to be subject to fiduciary duties when providing them with research if that would mean a diminution of the services they receive. Often, the most valuable aspects of a broker-dealer's research to an investment manager are the breadth, diversity, creativity and speed of its content. If a broker-dealer research provider were required to limit or filter its content to satisfy fiduciary standards under the Advisers Act (if satisfying such standards were even possible), that would be a disservice to investment managers who want to receive *all* of the Research Services that the provider has to offer and make their own decisions about what Research Services to use when making investment decisions for their clients. Imposing fiduciary duties on broker-dealer research providers applies an additional layer of duties onto entities that are not well positioned to undertake those duties—because they have fundamentally different business models and relationships—and would ultimately cause broker-dealer research providers to limit their Research Services, particularly Sales and Trading Content, in a way that would inhibit the ability of investment managers to satisfy their own fiduciary duties.

III. Consequences of Expiration of the Relief

Because of the fundamental incompatibilities between the Advisers Act and the Research Services and sales and trading services provided by many broker-dealers to MiFID II Managers, we expect that many broker-dealers will determine that moving all of their Research Services, including Sales and Trading Content, to an investment adviser to accommodate MiFID II Managers cannot be justified in light of the significant changes that they would have to make to their services and business models to avoid undue risks under the Advisers Act. As the business models of research providers and MiFID II Managers vary widely, we are concerned that we will not know the true severity of the impact of the expiration of the SIFMA NAL on the availability of research to MiFID II Managers[12] until the letter expires. However, based on our conversations with SIFMA members, we do expect that many broker-dealers will curtail the Research Services they provide to MiFID II Managers in reliance on the SIFMA NAL and focus instead on servicing investment managers and other institutional investors that remain willing and able to pay for Research Services in ways that do not implicate the Advisers Act, such as paying with client commissions or soft dollars.

When evaluating the costs and risks of this outcome, we believe that it is important for the SEC staff to consider the importance and benefits of investment research, both to the markets generally and to investment managers and their clients. The SEC has stated that "broad-based securities research and its prompt and fair dissemination to large and small investors is indispensable to an efficient system of securities markets."[13] The benefits of investment research can include improving the liquidity of issuers subject to coverage[14] and serving as an external governance mechanism by increasing corporate transparency, which can help deter corporate misconduct.[15] Investment research is particularly important to investment managers, as it provides them with critical information that they need in order to make informed investment decisions and satisfy their fiduciary duties to their clients.

We are very concerned that the expiration of the SIFMA NAL could result in a significant decrease in the quantity, quality, depth and diversity of the Research Services available to MiFID II Managers, which will ultimately have a negative impact on the services that MiFID II Managers provide to their clients and the efficiency of the markets.

IV. Potential Long-Term Solutions

The SEC and its staff have a number of different options for providing a permanent solution to these issues raised by MiFID II, and we provide a very high-level overview of several options below. Importantly, these options can be implemented without jeopardizing investor protection or the integrity of broker-dealer research. The solutions we propose are targeted at Research Services that are provided to MiFID II Managers. We emphasize that our intention is to simply preserve the ability of investment managers to continue to receive the Research Services pursuant to an existing regulatory framework that has worked well in protecting investors and the integrity of the markets. We are not seeking to exempt research providers from any of their existing regulatory obligations (*e.g.*, Regulation AC and FINRA Rules 2241 and 2242) or any obligations that are necessary to ensure the integrity of their research.

- *Reinterpretation of "special compensation" under Section 202(a)(11)(C) of the Advisers Act.* Research is comprehensively regulated under the broker-dealer framework, and we believe that broker-dealers should be able to continue to provide Research Services to MiFID II Managers outside of the investment adviser framework. To achieve this, the SEC could reinterpret the term "special compensation" for purposes of Section 202(a)(11)(C) of the Advisers Act to clarify that an SEC-registered broker-dealer does not receive "special compensation," and thus is not an investment adviser, where it charges separately or receives cash payments from a MiFID II Manager. This proposed reinterpretation of the definition of special compensation is

consistent with the intent of the Advisers Act, which clearly contemplates the regulation of investment advice provided by broker-dealers (including investment research) incidental to their primary business of effecting securities transactions under the Securities Exchange Act of 1934 (the "Exchange Act") rather than the Advisers Act, and is sound policy in light of the comprehensive framework for the regulation of research that already exists under the Exchange Act and FINRA rules.

- *Tailoring the scope of investment adviser fiduciary duties in the context of broker-dealer research relationships*. While we believe that an exemption from the Adviser Act is appropriate and consistent with the legislative intent behind the Advisers Act, the SEC or the staff could instead significantly mitigate the conflicts raised under Advisers Act regulation by issuing an interpretation or no-action relief that (i) confirms that the requirements of Section 206(3) of the Advisers Act do not apply to securities transactions executed by a broker-dealer with an MiFID II Manager where the broker-dealer's sole advisory relationship with the MiFID II Manager is the provision of Research Services, and (ii) would permit MiFID II Managers and broker-dealer research providers that are deemed investment advisers when providing Research Services to define their relationships such that the broker-dealer research provider's fiduciary obligations would be defined by agreement to exclude any fiduciary obligation with respect to any investment advice provided through its Research Services if (A) the broker-dealer research provider has a reasonable basis to believe that the MiFID II Manager is capable of evaluating investment risks independently, both in general and with regard to any investment advice provided through the research provider's Research Services, and (B) the MiFID II Manager affirmatively indicates that it is exercising independent judgment in evaluating the investment advice in the research provider's Research Services.[16]

- *Expand the relief in the BNY ConvergEx no-action letter.* As another alternative, the staff could expand the relief provided in the staff's no-action letter to BNY ConvergEx Group LLC ("BNY ConvergEx Letter")[17] by eliminating certain conditions in that letter that preclude most broker-dealers from relying on it. In the BNY ConvergEx Letter, the staff indicated that a broker-dealer could provide research to an investment manager without establishing an investment adviser/client relationship under the Advisers Act between the broker-dealer and the investment manager's managed account clients, subject to a number of conditions. This letter would more squarely address the issues faced by broker-dealers providing Research Services to MiFID II Managers if the staff were to issue a similar letter that excludes the conditions that (i) the MiFID II Manager exercise investment discretion, (ii) the client accounts not be affiliated with or proprietary to the MiFID II Manager, and (iii) the client accounts not be charged for the broker-dealer's advice. These changes would be needed because (i) many broker-dealers provide Research Services to investment managers with non-discretionary clients (and broker-dealers generally are never in a position to know if an order is placed by an investment manager that is exercising investment discretion or has obtained consent from the client), (ii) managers often have accounts or funds with significant proprietary stakes, and (iii) many MiFID II Managers, especially managers to hedge funds, use research payment accounts in which funds for research are contributed by clients pursuant to the requirements of MiFID II.

V. The Need for Immediate Relief

As we have discussed above, broker-dealers cannot solve the issues created by MiFID II by simply moving their Research Services to an investment adviser. There are fundamental inconsistencies between the typical business model for full-service research and sales and trading businesses and the Advisers Act, and only the SEC can address those inconsistencies. We are not aware of any misconduct or investor

protection concerns that have arisen as a result of the SIFMA NAL, and do not see any reason for urgency in allowing the relief to expire at this point in time. However, if the relief were allowed to expire, the disruptions to the market for investment research could be significant and irreversible and entirely unnecessary. We strongly encourage the staff to extend the relief in the SIFMA NAL *now* so that the current uncertainties can be resolved in the near term while the SEC and its staff can take whatever time is prudent to fully consider and implement a longer-term solution.

* * *

We appreciate the staff's engagement on this very important topic and look forward to a constructive dialogue with the staff. We strongly believe that broker-dealer research providers, investment managers and investors will be best served by the staff continuing to be proactive and crafting a thoughtful and policy-based response MiFID II, rather than allowing a foreign regulatory requirement to fundamentally change how research is structured and regulated under U.S. law.

This paper is intended to provide a high-level overview of the challenges posed by MiFID II and potential solutions, and we are happy to provide the staff with greater detail on anything that would help inform the staff's decision-making.

---

[1] *See* Directive 2014/65 of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments and Amending Commission Directive 2002/92 and Council Directive 2011/61, O.J. (L 173)57, 349 (available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2014:173:TOC) and equivalent national rules of member states. Under MiFID II, an investment manager is required to pay for research services from its own money, from a separate research payment account funded with its clients' money, or a combination of the two. In this paper, we will refer to such payments as "hard-dollar" payments.

[2] Research is defined broadly under MiFID II: "Research in this context should be understood as covering research material or services concerning one or several financial instruments or other assets, or the issuers or potential issuers of financial instruments, or be closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector. That type of material or services explicitly or implicitly recommends or suggests an investment strategy and provides a substantiated opinion as to the present or future value or price of such instruments or assets, or otherwise contains analysis and original insights and reach conclusions based on new or existing information that could be used to inform an investment strategy and be relevant and capable of adding value to the investment firm's decisions on behalf of clients being charged for that research." Commission Delegated Directive of July 4, 2016 Supplementing Directive 2014/65/EU. Notably, this definition is broader than the definition of "research report" under Financial Industry Regulatory Authority ("FINRA") rules.

[3] *See* Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (Oct. 16, 2017). The staff subsequently extended this relief through July 3, 2023. *See* Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (Nov. 4, 2019). These letters are collectively referred to herein as the "SIFMA NAL."

[4] *See supra* note 2.

[5] *See* Staff Report on the Issues Affecting the Provision of and Reliance Upon Investment Research Into Small Issuers (Feb. 18, 2022) at 29 n.118, available at https://www.sec.gov/files/staff-report-investment-research-small-issuers.pdf ("Staff Report on Small Issuer Research"), stating "See Michael Mayhew, Integrity Research Associates, Can Asset Managers Not Subject to MiFID II Use Cash to Pay for US Research?, Jan. 27, 2020, https://www.integrity-research.com/can-asset-managers-not-subject-mifid-iiuse-cash-pay-us-research/ ("At least five US brokers including Bank of America Merrill Lynch, Deutsche Bank, Jefferies, Nomura Securities and BMO Capital Markets previously decided to register their research departments as investment advisers to enable any asset manager to use cash to pay for their investment research."); *see also* Peter Smith & Robin Wigglesworth, *BofA Breaks Ranks to Take Investment Adviser Status Ahead of MiFID*, Fin. Times, Oct. 24, 2017, https://www.ft.com/content/b840973e-b803-11e7-

8c12-5661783e5589 ("BofA's decision to make its research unit a registered investment adviser allows the bank to accept hard dollars for US research services from any investor in the world."); Laura J. Keller, *BofA Inches Closer to U.S. Research Fees as MiFID Looms*, Bloomberg, Nov. 5, 2017, https://www.bloombergquint.com/markets/bofa-makes-legal-move-to-charge-for-u-sresearch-as-mifid-looms (observing that Deutsche Bank AG's investment bank included its research services in its investment adviser registration but indicated in its SEC filing that its research is provided through its broker-dealer status, not as an investment adviser).

[6] Section 206(3) makes it unlawful for any investment adviser, directly or indirectly, acting as principal for his own account, to knowingly (a) sell any security to a client or (b) purchase any security from a client ("principal trades") without disclosing to such client in writing before the completion of such transaction the capacity in which the adviser is acting and obtaining the consent of the client to such transaction. Section 206(3) requires an adviser entering into a principal trade with a client to satisfy these disclosure and consent requirements on a transaction-by-transaction basis. Section 206(3) also prohibits an adviser, directly or indirectly, acting as broker for a person other than the advisory client, from knowingly effecting any sale or purchase of any security for the account of that client without disclosing to that client in writing before the completion of the sale or purchase the capacity in which the adviser is acting and obtaining the consent of the client to the sale or purchase.

[7] Rule 206(3)-1 provides that a broker-dealer shall be exempt from Section 206(3) in connection with any transaction in relation to which such broker or dealer is acting as an investment adviser solely (1) by means of publicly distributed written materials or publicly made oral statements; (2) by means of written materials or oral statements which do not purport to meet the objectives or needs of specific individuals or accounts; (3) through the issuance of statistical information containing no expressions of opinion as to the investment merits of a particular security; or (4) any combination of the foregoing services; provided that such materials and oral statements include certain disclosures.

[8] Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1732 (July 27, 1998) (citing Hartzmark & Co., SEC Staff No-Action Letter (Nov. 11, 1973) (applying Section 206(3) when an adviser effects transactions through its broker-dealer parent)).

[9] *See* Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 27017, 54 Fed. Reg. 30,013, 30,021 (July 18, 1989).

[10] *See, e.g.*, *Chamber of Commerce of the USA, et al. v. US Dep't of Labor, et al.*, No. 17-10238, slip op. 46 (5th Cir. Mar. 15, 2018); *United States v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006); *United States v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002); *Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 212 (7th Cir. 1993); *MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Express Inc.*, 886 F.2d 1249, 1257 (10th Cir. 1989); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953-54 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981). *Cf. De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293 (2d Cir. 2002).

[11] *See* Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Advisers Act Release No. 5249 (June 5, 2019); 84 Fed. Reg. 33,681 (July 12, 2019).

[12] MiFID II has affected, and will continue to affect, investment managers located outside of the European Union and United Kingdom in a number of ways. For example, the requirements of MiFID II apply to an investment manager that delegates its investment management responsibilities to a manager located outside of the European Union, and requires the delegating manager to contractually obligate the other manager to comply with MiFID II's requirements regarding the unbundling of research. Additionally, due to the global and interconnected nature of many managers' businesses, a number of managers have responded to the complications caused by MiFID II by unbundling research payments being made by affiliates across their entire organization.

[13] SEC, Future Structure of Securities Markets, 37 Fed. Reg. 5,286, 5,290 (Mar. 14, 1972).

[14] *See* Staff Report on Small Issuer Research at 11-13 (citing Tung L. Dang et al., *Analysts and Stock Liquidity – Global Evidence*, COGENT ECON. & FIN. (2019), available at https://www.tandfonline.com/doi/full/10.1080/23322039.2019.1625480 (finding that firms' analyst coverage is positively related to stock liquidity, which confirms "the notion suggested in previous studies that analyst activities provide public information that reduces information asymmetries between firms and market participants")).

[15] *See* Staff Report on Small Issuer Research at 13-15 (citing Tao Chen et al., *Do Analysts Matter for Governance? Evidence From Natural Experiments*, 115 J. FIN. ECON. 383 (2014)).

[16] This interpretation or relief with respect to the research provider's fiduciary duties draws upon the framework for the institutional suitability exemption in FINRA Rule 2111(b).

[17] *See* BNY ConvergEx Group, LLC, SEC Staff No-Action Letter (Sept. 21, 2010).