SEC MiFID Stance Could Bring Implementation Challenges for Managers

By Dervedia Thomas March 21, 2019

The Securities and Exchange Commission signaled this week that it could take a hands-off approach to permanently dealing with issues created by European rules that change how managers access investment research. This may allow larger asset managers to steer the industry's implementation toward absorbing research costs, to the detriment of smaller shops.

The European Markets in Financial Instruments Directive (MiFID II) requires that managers separate payments for trading and research, rather than pay broker-dealers for investment research through trading commissions, or soft dollars. However, U.S.-based broker-dealers are prohibited from accepting such payments under the Advisers Act unless they register as investment advisers.

In October 2017, the US regulator issued no-action assurances to broker-dealers that receive payments or "hard dollars" from asset managers under the MiFID regime, but that relief expires in July next year.

However, the agency may not make these exemptions permanent, as industry players have already devised such methods to comply with the European directive, DIM Director **Dalia Blass**, said at the **Investment Company Institute**'s *Investment Management Conference* on March 18.

These methods include implementing reconciliation or reimbursement processes to make research costs more transparent, she said.

Asset managers have already begun to change their business models to respond to the rule. Firms such as Vanguard **Group**, T. Rowe Price and Capital Group have announced plans to absorb third-party research costs.

William Blair has boosted its research staff to reduce its reliance on third-party research. Larger firms may use their ability to cover research costs on their profit and loss statements as a competitive advantage, **Mike Carrodus**, founder and CEO of UK-based research platform **Substantive Research**, argues.

"You could continue to charge end investors and still have a simple life, [but] it will also depend on whether any firms think there is a competitive advantage of going P&L because they think they can absorb the costs more easily, retain the inputs that their PMs need, and put some of their competitors at a disadvantage," he says.

Larger asset managers are generally in a better position to augment their business models to handle reporting and can better track and disburse payments, **Jane Stabile**, president of **IMP Consulting**, notes.

Such managers are also in a better position to staff up, **Susan Grafton**, partner at Dechert, says.

"Smaller managers may not have the resources to build their own research departments, and even if they do, they might not have the range of research available to them that they could obtain from broker dealers," she says.

Asset managers are further challenged by their ability to convince the market to pay for research if they decide not to absorb such costs since it isn't a regulatory requirement, Carrodus adds.

"Is the U.S. industry confident and capable of outlining a robust case for continuing to charge end investors for research? In Europe, that conversation was dodged, and the market went P&L," he says. "My feel is that there are a number of asset managers in the U.S. who are definitely more prepared to have a robust discussion about risk and performance and why it is in the end investor interest for there to be a research market that encourages diversity, and where the portfolio managers have optionality in the inputs they receive."

Some small shops have changed their business processes to avoid the operational cost and complexities associated with the rules. For example, they may execute certain trades outside Europe, Stabile explains.

"Rather than having a PM or trader in the U.K. handle investment decisions and trading, they might turn those responsibilities over to U.S. staff," she says.

To convince the SEC that permanent exemptions are paramount, asset managers would have to make a more compelling and granular case, according to Grafton.

"The SEC staff appears to be looking for specific data and statistics to support the industry view that the no-action letter relating to broker-dealers' investment adviser status should be made permanent and expanded," she said.

Contact the reporter on this story at dthomas@fundfire.com or 212-542-1237.