Financial Markets Law Committee ("FMLC")

Securities Markets Scoping Forum

Date: Wednesday 12 June 2019

Time: 9am to 10.30am

Location: Bank of England, Threadneedle Street, London, EC2R 8AH

Please kindly note that you will not be allowed access to the building without photo ID (passport or driving licence only).

In Attendance:

Raj Panasar (Chair)	Cleary Gottlieb Steen & Hamilton LLP
Mark Chalmers	Davis Polk LLP
Daniel Csefalvay	Bryan Cave Leighton Paisner LLP
Leland Goss	International Capital Market Association
Matthias Lehmann	University of Bonn
Stephanie Lincoln	Deutsche Bank AG
Kristina Locmele	Slaughter and May
Michael Sholem	Cadwalader, Wickersham & Taft LLP
Ferdisha Snagg	Cleary Gottlieb Steen & Hamilton LLP
Eleanor Ley	Allen & Overy LLP
Madeleine Wanner	Linklaters LLP
James Warbey	Milbank LLP
Eleanor Hooper	FMLC
Venessa Parekh	FMLC

Guest Speaker

David Bloom	SunTrust Banks, Inc

Apologies:

Carter Brod	Morgan, Lewis & Bockius UK LLP
Andrew Bryan	Clifford Chance LLP
Mindy Hauman	White & Case LLP
Carolyn H. Jackson	Katten Muchin Rosenman UK LLP
James Scoville	Debevoise and Plimpton LLP
Alasdair Steele	CMS Cameron McKenna Nabarro Olswang LLP
Tom Falkus	White & Case LLP

Minutes:

1. Introductions

1.1. Mr Panasar opened the meeting. Attendees introduced themselves.

2. Administration: FMLC in Numbers (Venessa Parekh)

2.1. Ms Parekh delivered a short presentation on the FMLC's work, highlighting key numbers in relation to Scoping Forums, Working Groups, events and budget.[1]

3. The Impact of MIFID II on the US Market (David Bloom)

3.1. Mr Bloom introduced himself to Forum members. He stated that his remarks would focus on the rules in Directive 2014/65/EU on markets in financial instruments ("**MiFID II**") which require asset managers to "unbundle" payments for execution from associated "inducements" such as research and the manner in which these rules interacted with U.S. law and regulations.[2]

3.2. First, Mr Bloom provided a brief overview of the U.S. regulatory framework. Section 28(e) of the U.S. Securities Exchange Act 1934 (the "**Exchange Act**") provides a safe harbour that protects money managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate in order to receive "brokerage and research services" provided by a broker-dealer if the managers determine in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services. Traditionally, money managers in the U.S. have received research as part of their commission arrangements with broker-dealers. The other relevant piece of legislation is the Investment Advisers Act 1940 (the "**Advisers Act**", which provides definitions for the term "investment adviser". Additionally, the U.S. Securities Exchange Commission (the "**SEC**") and the Financial Industry Regulatory Authority ("**FINRA**") have set out rules pertaining to broker-dealers' research analysts.

3.3. As MiFID II requires that research is unbundled from services offered by broker-dealers, in 2017, the SEC granted a temporary reprieve (until July 2020) for U.S. broker-dealers providing research to investment managers that fall within the scope of MiFID II. Mr

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[1] See Appendix I, below.

[2] For speaking notes, see Appendix II, below.

Bloom stated that research providers in the U.S. have relied on this relief in order to be able to comply with both MiFID II and the SEC and FINRA research rules. Approximately one year after MiFID II came into force, the SEC had published a request for public comment on the research services landscape.[3] Responses urged the SEC to provide permanent relief by allowing broker-dealers to charge separately or receive cash payments for research provided to investment managers and other institutional investors without the broker-dealers being deemed investment advisers subject to the Advisers Act.

3.4. Mr Bloom then recounted a speech delivered by the Director of the SEC's Division of Investment Management in March 2019, which acknowledged the development of market solutions, such as fund managers using reconciliation or reimbursement processes to deliver cost transparency. The speech indicated that the SEC was unconvinced at that time that a blanket exemption from the Advisers Act would be appropriate but that it would support such market-based solutions with targeted relief from full compliance with all of the requirements of the Advisers Act.

3.5. Finally, Mr Bloom turned to the market impact of MiFID II in the U.S. including increased demand from fund managers to unbundle, decreased availability of research, and adverse impact on investment performance. Regarding the availability of research, he noted that MiFID II had accelerated the general trend of shrinking research budgets in the U.S. Tighter research budgets mean that research focuses on larger issuers at the expense of smaller ones, exacerbating the difficulties faced by smaller companies in accessing the capital markets and maintaining market liquidity in their securities.

3.6. Forum members were invited to ask questions. One attendee asked if the SEC required broker dealers providing research on an unbundled basis to register as investment advisers, whether there was a relationship between the fiduciary responsibility undertaken by investment managers and the quality of research provided. Mr Bloom agreed that research was expected to be more cautious; an issue which had been flagged by market participants to the SEC. Another attendee noted that the "unbundling" requirement in MiFID II had its roots in clients' concerns that investment managers had expenditures which benefitted themselves rather than the client. Attendees agreed that the "unbundling" requirement had given rise to unintended consequences. A Forum member observed that if the U.S. regime placed a fiduciary responsibility on the research provider, whether the provider was also bestowed, correspondingly, with a duty of care towards those to whom the research was not

[3] SEC, Press Release: *SEC Staff Encourages Continued Engagement on Impact of MiFID II Research Provisions*, (21 December 2018), available at: https://www.sec.gov/news/press-release/2018-301.

targeted. Attendees noted that this would be a tricky argument under English law and Mr. Bloom indicated that while he was not aware that the question had been formally considered yet in the U.S., he noted that any such liability should be manageable. Finally, an attendee asked about the specific point of contact with an E.U. client or market participant which would trigger the need for a U.S. broker-dealer to comply with MiFID II. It was explained that the MiFID II rules apply to research provided by any third party (regardless of where that party is located) to an EU portfolio manager or their third country delegate.

4. Plenary discussion on recent and anticipated legislation and developments—potential areas of focus for future meetings (Ferdisha Snagg)

4.1. Ms Snagg stated that she had put together a list of developments, all of which were not necessarily relevant to this Forum. One issue in which the Forum expressed interest was the entry into force of the amendment to Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories (the "**EMIR Refit**"), and its implications for alternative investment funds. Additionally, Ms Snagg noted that the Law Commission had initiated a project on intermediated securities. A call for evidence was expected in summer 2019. Ms Snagg suggested that this should be discussed at a future meeting, given existing uncertainties in respect of ownership of electronic securities. Forum members agreed.

4.2. Forum members briefly discussed Regulation (EU) No 1286/2014 on key information documents for packaged retail and insurance-based investment products (the "**PRIIPs Regulation**") and the difficulties in identifying exactly what products are in its scope. Ms Snagg noted that the European Commission had begun a review of Regulation (EU) No 596/2014 on market abuse (the "**Market Abuse Regulation**" or "**MAR**"). A Forum member remarked that the European Commission's assessment of the delay of disclosure of inside information by issuers under MAR should be monitored as it raises an issue of legal uncertainty. Finally, Ms Snagg drew attention to the Independent Review being led by Sir Donald Brydon into the quality and effectiveness of the U.K. audit market and suggested that the Report, when published, might be of interest to Forum members.

5. Any other business

5.1. Mr Bloom asked about the preparations being undertaken by U.K. market participants for the discontinuation of the London Inter-bank Offered Rate ("**LIBOR**"). A brief discussion followed.

5.2. No other business was raised.

Did you know ..?

A quick glance at some FMLC numbers

Venessa Parekh

Addressing legal uncertainty

Since 2003, the FMLC has analysed and made recommendations to resolve legal uncertainties in 222 disparate topics.

Solvency II

E.U. Data Protection Reform

Brexit

Market Abuse Regulation

EMIR

Emissions Allowances

Benchmarks Reform

Bail-in

Capital Markets Union

Sovereign Debt Collective Action Clauses

Rome I

Bank Reform (Ring Fencing)

International Coordination of Law and Regulation

Regulation of Credit Rating Agencies

MiFID II

Bank Recovery and Resolution

Financial Market Infrastructures

Virtual Currencies

FMLC research is conducted through:

9 Scoping Forums

- Asset Management
- Banking
- Brexit
- Infrastructure
- Insurance
- Fintech
- Securities
- Sovereign Debt
- Quarterly Discussion Forum (closed)

4 Working Groups

… are currently active. Two deal with matters related to Brexit.

In order to be agile in its responses to Brexit statutory instruments, the FMLC did not establish Working Groups but liaised with relevant experts to conduct a review and publish its results.

FMLC Publications

16 publications were produced in 2018

8 publications were on the U.K.'s withdrawal from the E.U.

7 publications on the review of Brexit-related statutory instruments (between August 2018 to April 2019).

2018-Present FMLC Events

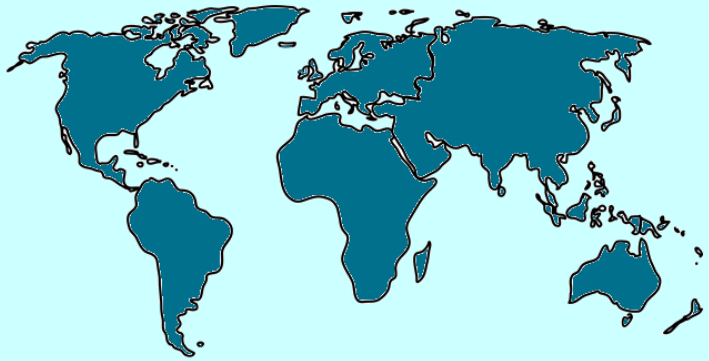
5 formal events were held.

12 guest speakers across all events.

85 guests attended the Autumn Seminar on Incorporating E.U. Law into the U.K. Domestic Framework, the most attended FMLC event of 2018.

International connections

- **15** speeches were given by the FMLC CEO in 4 different countries
- **4** calls are held every year with the Financial Markets Lawyers Group ("FMLG") (New York)
- **3** sister organisations (associated with the Federal Reserve, the ECB and the Bank of Japan) participate in an annual conference with the FMLC
- **7** jurisdictions (E.U., Hong Kong, Japan, Switzerland, Singapore, U.K. and U.S.) hold a biannual information-exchange video conference



People and the FMLC

- 37 patron organisations
- 52 average number of members per Scoping Forum
- 28 Committee Members
- 24 average number of members per Working Group
- 8 staff at the FMLC Secretariat (including 2 staff members on maternity leave)

Looking under the hood …

£396,000* Projected 2019 budget

- Budget is accrued unevenly from donations by:
  - Bank of England
  - City Remembrancer's Office for the City of London Corporation
  - Association for Financial Markets in Europe
  - AIG Europe Limited
  - Lloyd's of London
  - Around 30 law firms
  - Other market participants

83% Percentage of charitable income spent on Secretariat salaries

- £329,000.00* will be spent on Secretariat salaries in 2019.
- The rest of the budget goes towards administrative costs and inviting/funding foreign experts to share their expertise at the FMLC educational events.
- The Bank of England bears many of our overheads and is the largest donor when this is taken into account.

*All figures rounded to nearest £000

You can get involved in the FMLC's work by becoming a:

- **patron**
- **stakeholder**
- **recipient to our general mailing list**

for a sample Patrons' Newsletter, a copy of the FMLC donation pack, or for a sample Stakeholders' Newsletter and any other enquiries, or should you wish to receive regular notifications about new FMLC publications, please contact: Debbie Hayes (secretarial@fmlc.org).

THE IMPACT OF MIFID II ON THE US MARKET

David T. Bloom, Senior Vice President and Deputy General Counsel - Wholesale, SunTrust Banks, Inc.

June 2019

I. MiFID II Rules:

- Require money managers to "unbundle" payments for execution from associated "inducements" which include research.

- Do not permit EU investment firms providing portfolio management or investment advice to accept fees, commissions or any benefits from third parties for providing services to clients.

II. U.S. Legal Landscape:

- **Section 28(e) of the Securities Exchange Act of 1934; the so-called "Soft Dollar" Safe Harbor for Money Managers:**

- Section 28(e) of the Securities Exchange Act ("Exchange Act") provides a safe harbor that protects money managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate in order to receive "brokerage and research services" provided by a broker-dealer if the managers determine in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services. This allows managers to pay in excess of the lowest possible commission for execution if they get fair value for brokerage and/or research. Traditionally, money managers in the U.S. have received research as part of their commission arrangements with broker-dealers.

- Section 28(e) requires that the broker-dealer receiving commissions for "effecting" transactions must "provide" the brokerage or research services. In July 2006, the SEC interpreted the safe harbor provided by Section 28(e) to apply to money managers who use client commissions to pay for research produced by someone other than the executing broker-dealer, in certain circumstances (referred to as "third party research"). The SEC also has clarified that research provided in third party arrangements is eligible under Section 28(e) even if the money manager participates in selecting the research services or products that the broker-dealer will provide. In addition, the SEC has stated that the third party also may send the research directly to the broker dealer's customer. To come within the Section 28(e) safe harbor, the credits must be accrued with a broker-dealer who had some role in effecting a particular trade. Client commission

arrangements, also known as CSAs, to pay for research services were recognized by this 2006 SEC interpretation.

- **Section 202(a)(11)(C) of the Investment Advisers Act; a Safe Harbor For Broker-Dealers Providing Research:**

- Under the Investment Advisers Act of 1940 ("Advisers Act"), an "investment adviser" is defined as any person or firm that: (1) for compensation; (2) is engaged in the business of; (3) providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications. A person or firm must satisfy all three elements to be regulated under the Advisers Act.

- A firm that falls within the definition of "investment adviser" (and is not eligible for one of the exclusions) must register under the Advisers Act.

- "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" is excluded from the definition of an investment adviser. This raises the issue as to whether U.S. broker-dealers can accept hard dollars for research without being deemed to have accepted "special compensation" for investment advice and, therefore, need to register as investment advisers. Registered advisers are required to:

    - Establish a compliance program.
    - Comply with principal trading and cross trade restrictions under the 1998 Section 206(3) Interpretation.
    - Comply with books and records, advertising, and disclosure requirements under the Advisers Act.
    - Disclose on their Form ADV the firms' potential conflicts of interests.

- **Rules Applicable to Broker-Dealer Research:**

- The SEC and FINRA already have rules regarding research that pertain to broker-dealers' research analysts:

- FINRA Rules 2241 and 2242 require analysts and their supervisors to pass the Series 16, 86 and 87 qualification examinations

- SEC adopted Regulation Analyst Certification ("Regulation AC")

- **October 2017 SEC MiFID II Relief:** In October 2017, the SEC Division of Investment Management Staff issued a No-Action Letter which provided that for the first 30 months after the implementation of MiFID II (i.e., until July 3, 2020), a U.S. broker-dealer may provide research to investment managers subject to MiFID II directly or by contractual obligation in exchange for cash payments, or payments from a research payment account, without being treated as investment advisers under the Advisers Act. At the same time, the Division of Trading and Markets Staff issued a No-Action Letter which permitted money managers to continue to rely on the Section 28(e) Soft Dollar Safe Harbor when paying broker-dealers for research and brokerage. The US research industry has relied on this relief in order to be able to comply with both MiFID II and the SEC and FINRA research rules.

- **December 2018 SEC Request for Public Comment:** On December 21, 2018, the SEC Staff requested additional public comment on the current research services landscape and, in particular, possible next steps with respect to MiFID II relief. Numerous comment letters were submitted including by the securities industry trade body SIFMA which urged the SEC to provide permanent relief by rule or exemption allowing broker-dealers to charge separately or receive cash payments for research provided to investment managers and other institutional investors without the broker-dealers being deemed investment advisers subject to the Advisers Act (the "2019 SIFMA Comment Letter").

- **Dalia Blass, Director, SEC Division of Investment Management, Keynote Address at the ICI Mutual Funds and Investment Management Conference (March 18, 2019):** Addressed how MIFID II raised questions concerning market practice and compliance among broker-dealers and asset managers in the U.S. Director Blass: (a) noted that "market solutions" are developing that may make extending the no-action relief unnecessary citing that some fund managers using reconciliation or reimbursement processes to deliver cost transparency while addressing compliance and some broker-dealers have explored or taken steps to offer research through a registered advisory business, and (b) indicated that while the Division Staff was not convinced at this stage that a blanket exemption from the Advisers Act would be appropriate for research providers to institutional asset managers, they were open to considering suggestions to support "market solutions" with targeted relief from full compliance with all of the requirements of the Advisers Act, as appropriate.

III. US Market Impact:

- **Demand for Hard Dollars:** Driven in large part by MiFID II, global money managers, and in some cases U.S. money managers, have begun requesting U.S. broker-dealers to be able to pay for research with hard dollars.

- **Availability of Research**: The 2019 SIFMA Comment Letter highlights that unbundling has led to tighter research budgets for investment managers and, consequently, reductions in research teams and the depth and breadth of research coverage. There is a trend toward coverage of larger issuers at the expense of smaller ones which exacerbates smaller company difficulties in accessing the capital markets and maintaining market liquidity in their securities:[1]

- **Investment Performance:** A recent study by Frost Consulting indicates that US managers (primarily using client money) are outspending European managers (using their own P&Ls) at factors of 3:1 to 6:1, depending on the equity category. The Frost research makes clear that 2018 was the first year in which there was a stark divergence in research spending between the US and Europe. The Frost research found that the US managers outperformed the European managers. [2]

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[1] *See* Michael Mayhew, MiFID II Causes Research Sales to Fall Again in 2019, INTEGRITY RESEARCH ASSOCIATES (Jan. 28, 2019), available at http://www.integrity-research.com/mifid-ii-causes-research-sales-fall2019/; Hannah Murphy, UK Mid-Caps Suffer Drop in Liquidity and Analyst Coverage, FINANCIAL TIMES (July 30, 2018), available at https://www.ft.com/content/21e8b5de-91ae-11e8-bb8f-a6a2f7bca546; Mike Sheen, MiFID II Drives Liquidity Drought as Broker Research Coverage Falls, INVESTMENT WEEK (July 30, 2018), available at https://www.investmentweek.co.uk/investment-week/news/3036758/mifid-ii-drives-liquidity-drought-as-brokerresearch-coverage-falls; Research Analysts' Existential Crisis Enters MiFID II Era (Bloomberg) January 3, 2019, available at https://www.bloomberg.com/news/articles/2019-01-03/the-research-analyst-s-existential-crisis-enters-mifid-ii-era; and Why MiFID II Isn't Working as Intended and Investors are Losing as a Result (Melius Research) December 6, 2018, available at http://www.integrity-research.com/mifid-ii-isnt-working-intended-investors-losing-result.

[2] **Desperate Times Call for New Approaches: Substantial Underperformance of European Managers Post-MiFID II Requires Fresh Thinking** (*May 22, 2019*).