

The Impact of the EU Requirement to ‘Unbundle’ Research Costs

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A recent European Union (EU) directive prohibits certain investment managers from receiving securities research whose cost is "bundled" together with broker-dealers' costs of effecting securities transactions directed by the investment managers. So, beginning January 3, these investment managers must pay separately for such research with their own assets or with client assets held in "research payment accounts" meeting specified requirements.

Even in cases where the EU directive does not apply, this development will probably result in:

- more broker-dealers "unbundling" (i.e., charging separately for) their execution and research services), and
- more investment managers seeking out such unbundled arrangements, with the investment managers themselves absorbing any research costs.

Any such trends could be important for almost any type of securities investment account, including general or separate investment accounts of insurance companies, mutual funds in which such separate accounts may invest, and other accounts managed by individuals or companies affiliated with insurance companies or market insurance products.

Some broker-dealers have been concerned that their receipt of "unbundled" payments for research, as mandated by the EU directive, would require them to register with the SEC as investment advisers. The SEC staff, however, issued an October 26 letter that, in effect, temporarily suspends any such adviser registration requirement. Among other conditions, this relief applies only to payments made by investment managers that are domiciled in the EU (and therefore are directly subject to the directive) or are indirectly subject to the directive because of certain types of "contractual obligation." This temporary relief expires July 3, 2020. By then, the SEC hopes to have determined whether the relief should be continued, withdrawn, or modified.

Also on October 26, the SEC staff issued two other letters that facilitate "unbundling" by permitting investment managers, subject to conditions, to:

- aggregate securities transaction orders for clients who pay different amounts for research as permitted by the EU directive, if the investment managers are subject to the directive (either directly or pursuant to a contractual obligation), and
- rely on the safe harbor in Section 28(e) of the Securities Exchange Act of 1934 with respect to their use of research payment accounts as provided for under the directive