RESEARCH À LA CARTE: WHY THE UNITED STATES SHOULD PERMIT UNBUNDLED COMMISSIONS FOLLOWING MIFID II

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ABSTRACT

The United States and the European Union have fundamentally different laws governing how broker-dealers must charge investors for investment research. Brokers in the European Union must provide unbundled research to comply with the Markets in Financial Instruments Directive II (MiFID II), and brokers in the United States must provide bundled research to avoid registration as a Registered Investment Adviser (RIA). These laws have been in conflict for many years, but a No-Action letter from the SEC has stayed any major conflict with MiFID II's unbundled approach. Previous research has shown that MiFID II's unbundled research payments are better for investors because they are more transparent, are more market efficient, and more effectively prevent fraud. With the expiration of the SEC's No-Action letter in July 2023, this Comment utilizes this past evidence to argue that the SEC must adopt unbundled research payments to comply with the SEC's statutorily mandated mission to protect investors, maintain efficient markets, and facilitate capital formation.

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INTRODUCTION

The United States and the European Union have the world's most integrated economic relationship.[1] Thus, the financial markets of these regions have an enormous impact on each other. When the laws of the United States and the European Union are in conflict, more investors are affected. Broker-provided investment market research is no exception to this relationship. Despite this integration, the United States and the European Union have had fundamentally different approaches to regulating market research that brokers purchase.

Many brokerage firms operate in both Europe and the United States, so any radical differences between the bodies of law can cause major disturbances to firms' business operations.[2] The method by which

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[1] *EU Trade Relations with the United States. Facts, Figures, and Latest Developments*, EUR. COMM'N, https://policy.trade.ec.europa.eu/eu-trade-relationships-country-and-region/countries-and-regions/united-states_en#:~:text=The%20European%20Union%20and%20the,and%20investment%20partner%20by%20far [https://perma.cc/2UKJ-QEG2] (last visited Oct. 2, 2022).

[2] One American policy institute stated upon MiFID II's release that, "[t]his conflict of law not only hampers competitiveness of U.S. broker-dealers abroad, it also threatens the important production and sharing of equity research at home and abroad." Meghan Milloy, *U.S. – E.U. Conflict of Broker-Dealer Laws Hinders Important Equity Research*, AM. ACTION F. (Oct. 18, 2017), https://www.americanactionforum.org/insight/u-s-e-u-conflict-broker-dealer-laws-hinders-important-equity-research/ [https://perma.cc/4UVP-J528].

broker-dealers pay for investment research in Europe versus the United States has caused one such major disturbance. Multinational brokerage firms will have to comply with two different sets of rules. The firms must sort out which transactions must comply with which body of law, or both, making the process of paying for research and charging it to the investor even more inefficient, simply due to the existence of the conflict of law.

Broker-dealers provide investors with market research to assist them in devising investment strategies.[3] Broker-dealers in the United States and the European Union are paid for the research they supply in two very different ways.

Broker-dealers can be subject to the Security and Exchange Commission's (SEC) Advisers Act of 1940 if they provide unbundled payments.[4] The Act requires vendors to combine, or "bundle" research payments with investors' commissions, rather than charge for the research separately. If the broker-dealer fails to comply, then the broker must register as a Registered Investment Adviser (RIA). RIAs have far more regulatory and reporting requirements than unregistered advisors.[5]

In contrast, the EU's Revised Markets in Financial Instruments Directive (MiFID II), which took effect in 2018,[6] requires that managers pay for research separately from commissions.[7] Brokers in the European Union must provide unbundled research to comply with MiFID II, and brokers in the United States must provide bundled research to avoid registration as an RIA. This conflict necessitates a resolution for brokers who provide research in both jurisdictions. The US approach benefits brokers because it subjects them to less regulation. Alternatively, the EU approach allows for greater transparency and a deeper understanding amongst investors regarding the research they are purchasing.

As a temporary measure, the SEC issued a No-Action letter to mitigate the conflict, stating it would not take regulatory action against brokers who must comply with MiFID II and the Advisers Act. This letter stated it would not require a broker to register under US law when also

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3 Paul G. Mahoney, *Soft Dollars, Hard Choices: Reconciling U.S. and EU Policies on Sell-Side Research*, 75 BUS. LAW. 2173, 2174 (2020).

4 *See generally* Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21.

5 *See id.* § 80b-3.

6 *See generally* Commission Delegated Directive 2017/593, Supplementing Directive 2014/65/EU of the European Parliament and of the Council with Regard to Safeguarding of Financial Instruments and Funds Belonging to Clients, Product Governance Obligations and the Rules Applicable to the Provision of Reception of Fees, Commissions or any Monetary or Non-Monetary Benefits, 2017 O.J. (L 87) 500 [hereinafter *MiFID II Supplement*].

7 *Id.* at 503.

under the jurisdiction of the European Union and MiFID II's unbundling requirements. The No-Action letter ensured the SEC would not bring an enforcement action[8] against a broker complying with MiFID II for failing to register as an RIA, and the letter was extended several times.[9] This letter and its subsequent extensions expired in July 2023,[10] and prior to its expiration, the SEC stated it would not issue another extension.[11] Today, the two approaches to research payment are still in conflict. The US House of Representatives introduced a bill in April 2023 that would prevent the July 2023 conflict.[12] But the bill has not made it out of Congress.[13] Broker-dealers in Europe do not want to reorganize their business structures to comply with the United States' less efficient, less investor-friendly approach. And broker-dealers in the United States do not want to reorganize their business structures to fit one European rule.[14]

As a result of the letter's expiration, the United States should change its research payment policy to eliminate conflicts between the two bodies of law. After MiFID II took effect in 2018, the SEC took a "wait and see attitude"[15] to MiFID II. Four years later, research shows that the unbundled approach is ultimately better for investors.

The three core facets of the SEC's mission since its inception have been to protect investors, ensure efficient markets, and facilitate capital

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[8] An enforcement action is an administrative power of the Securities and Exchange Commission. LINDA CHATMAN THOMSEN, SEC, AN OVERVIEW OF ENFORCEMENT 1 (2005), https://www.sec.gov/about/offices/oia/oia_enforce/overviewenfor.pdf [https://perma.cc/MP7K-E6N7]. Under the Adviser's Act of 1940, the Division of Enforcement has the power to bring a suit in United States District Court to seek an injunction against alleged securities law violations. *Id.*

[9] Securities Industry and Financial Markets Association, SEC Staff No-Action Letter, 2017 SEC No-Act. LEXIS 351 (Oct. 26, 2017).

[10] Press Release, SEC, SEC Announces Extension of Temporary Measure to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions (Nov. 4, 2019), https://www.sec.gov/news/press-release/2019-229 [https://perma.cc/57X8-4W7M].

[11] William Birdthistle, Director, Div. of Inv. Mgmt., SEC, Remarks at PLI: Investment Management 2022 (July 26, 2022), https://www.sec.gov/news/speech/birdthistle-remarks-pli-investment-management-2022-072622 [https://perma.cc/R58D-EUNX].

[12] *See* H.R. 2622, 118th Cong. (as introduced in House, April 13, 2023).

[13] *Id.*

[14] Jennifer Hughes, *US Banks Still Scrambling to Meet Mifid Challenge,* FIN. TIMES (June 10, 2023), https://www.ft.com/content/b5bee977-ba6d-4b12-90a0-1451ff4d5d1f [https://perma.cc/MZR9-TZDQ].

[15] Howell E. Jackson & Jeffery Zhang, *The Law and Economics of Soft Dollars: A Review of the Literature and Evidence from the Implementation of MiFID II*, 42 REV. BANKING & FIN. L. (forthcoming 2023) (manuscript at 4–5), https://ssrn.com/abstract=3673470 [https://perma.cc/5T22-G656].

formation.[16] If the unbundled approach is better for investors, and ensures a more efficient research market, the SEC should embrace unbundled research commissions to fulfill its mission.

Part I of this Comment will introduce the securities research market, and then provide a brief history on how that market is regulated in the United States and the European Union. Part II will analyze the current state of the EU-US law conflict. Part III will discuss how to change the current law in the United States, and why it should be changed. Ultimately, this Comment recommends that the United States change its law to allow unbundled commissions because unbundled commissions better encompass the SEC's mission and protect against fraud.

I. BACKGROUND

A. THE BROKER-DEALER RESEARCH MARKET

The relationships between broker-dealers, customers, and managers are complex. Broker-dealers and investment advisers are separate roles that are regulated differently under US law. In broker-dealer relationships, there is a broker-dealer and a customer. The customer could be a manager or an ordinary investor, depending on whether the customer is purchasing a security directly or as a client of a manager. In this relationship, the customer or manager asks the broker to execute a sale for them, and the broker executes the sale as an agent.[17] By contrast, the SEC more heavily regulates the investment advisor–customer relationship. A customer and investment adviser relationship requires that the adviser owe ongoing fiduciary duties to the customer and manage the customer's assets.[18] Broker-dealer relationships do not have these responsibilities. Historically, broker-dealers were subjected to a suitability standard, where the broker-dealer does not have fiduciary duties but must recommend investments that are suitable to the client. With the converging roles of broker-dealers and RIAs, the SEC adopted an additional rule, requiring

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[16] *Mission*, SEC, https://www.sec.gov/about/mission [https://perma.cc/A8EK-88HR] (last visited Sept. 17, 2023).

[17] Mahoney, *supra* note 3, at 2173.

[18] *Id.* at 2175; 15 U.S.C. § 80b-6 (explaining that Registered Investment Advisers are prohibited from defrauding clients or prospective clients; engaging in fraudulent transactions; selling or purchasing a security from a client for his own account acting as principal; and engaging in any fraudulent, deceptive, or manipulative practices).

that the broker-dealer must act in retail investors' best interests.[19] In short, broker-dealers help execute trades, whereas an adviser has a longer-term relationship with the investor.

As a result of these two structures, broker-dealers have a less formal relationship with their customers, so they sometimes bundle their research fees and commission by transaction. Advisers, by contrast, are paid from a fee[20] based on the value of the account as a whole, and research is charged separately.[21]

Since broker-dealers and investment advisers are different, the way that the person may pay for investment research also differs. Research that is paid for as part of the broker's commission fee is called a "bundled" commission, "soft dollar," or "commission sharing agreement" because brokers may use commission dollars to pay for research rather than charging separately.[22] Research that is paid separately from a commission is called a "hard dollar" or "unbundled" payment.[23] The concept is based on whether the specific research itself is being charged to the customer (unbundled), or if the customer is being charged a general research fee included within commission without specifically stating what the fee has paid for (bundled).

B. BROKER-DEALER RESEARCH REGULATIONS IN THE UNITED STATES

To understand securities research payment regulation in the United States, both the laws and regulations that affect broker-dealers and managers must be examined. First, this Comment will describe the SEC's history. Next, this Comment will describe the various regulations that concern broker-dealers in the United States. Then, it will detail regulations for managers in the United States.

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[19] *Suitability*, FINRA, https://www.finra.org/rules-guidance/key-topics/suitability [https://perma.cc/XG6X-YL7C] (last visited Mar. 6, 2023); SEC Regulation Best Interest, 17 C.F.R. § 240.15l-1 (2022) (stating that when broker-dealers make a recommendation to a retail investor, they must, "[a]ct in the best interest of the retail customer at the time the recommendation is made . . .").

[20] The average RIA fee in 2019, the most recent year with data was 1.17% of assets under management (AUM). Kate Ashford, *What is a Registered Investment Advisor (RIA)?*, FORBES (June 14, 2023), https://www.forbes.com/advisor/investing/financial-advisor/ria-registered-investment-advisor/ [https://perma.cc/L24K-ZAVH].

[21] Mahoney, *supra* note 3, at 2173.

[22] *Payment for Research*, CFA INST. (Nov. 1, 2019), https://www.cfainstitute.org/en/advocacy/issues/payment-investment-research#sort=%40pubbrowsedate%20descending [https://perma.cc/GRX8-DM6L].

[23] *Id.*; *see* Mahoney, *supra* note 3.

1. A Brief History of the SEC

Congress created the SEC after the stock market crash of 1929.[24] Prior to its existence, people purchasing and selling securities had almost no government oversight.[25] After the stock market crashed, Congress held hearings to determine the cause of the economic downfall and devise solutions.[26] The hearings, known as the Pecora Hearings, found that financial institutions purposely misled investors about the "desirability of certain securities" and rewarded insiders.[27] The Pecora Hearings allowed Congress and the president to determine that more government oversight was necessary in the securities markets to prevent another Great Depression.[28]

As a result of these findings, Congress passed the Securities Act of 1933, which required registration of all securities sales.[29] The premise was that registration of transactions would make it less likely that ordinary investors would be misled because of the legitimacy that registration offers and the requirement to provide a prospectus to potential investors.[30] Following this, Congress passed the Securities Act of 1934, creating the SEC[31] to restore investor confidence in capital markets after the 1929 crash and require informational disclosures to investors.[32] As a result, companies were required to disclose risks of investing and truthfully explain what they were selling. Generally speaking, both acts require that investor interests are respected over the interests of sellers (i.e., brokers).[33] Since the 1930s, the SEC has expanded its activities significantly, but its core mission remains the same: to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.[34]

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[24] SEC Hist. Soc'y, *Timeline*, VIRTUAL MUSEUM & ARCHIVE OF THE HIST. OF FIN. REGUL., https://www.sechistorical.org/museum/timeline/1930-timeline.php [https://perma.cc/HA2R-FYD3] (last visited Mar. 7, 2023).

[25] *See generally* David A. Moss et al., The Pecora Hearings (Feb. 13, 2009) (unpublished manuscript), https://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2009-1116-Moss-article-2.pdf [https://perma.cc/622B-EFA5].

[26] SEC Hist. Soc'y, *supra* note 24.

[27] Moss et al., *supra* note 25.

[28] SEC Hist. Soc'y, *supra* note 24.

[29] *See id.*

[30] *See id.*

[31] *Id.*

[32] SEC, AGENCY AND MISSION INFORMATION 10 (2014), https://www.sec.gov/about/reports/sec-fy2014-agency-mission-information.pdf [https://perma.cc/AK4D-DD4E].

[33] *Id.*

[34] *Mission*, *supra* note 16.

2. *Regulations for Broker-Dealers*

One of the expansions made after the creation of the SEC was the registration requirement for investment advisers under the Advisers Act of 1940.[35] The Act dictates when the adviser must register as an RIA.[36] Broker-dealers can avoid becoming RIAs when they provide research to customers. RIAs are subject to significantly more regulatory oversight than broker-dealers. RIAs must implement compliance programs, file a yearly form ADV,[37] provide written disclosure statements to prospective clients, implement an ethics policy, monitor and enforce insider trading policies, keep more detailed books and records,[38] submit SEC examinations, and more.[39] The regulations with which firms must comply for RIA status come at a significant opportunity cost. Firms must invest a significant amount of effort, time, and money to draft new policies, hire new staff, and enact other measures that are necessary to comply with RIA requirements. Therefore, it is important to broker-dealers that they do not inadvertently engage in activities that would subject them to the RIA's regulatory regime. Unbundled payments for research could subject a broker to the RIA registration requirements because unbundled payments do not fit under the exemptions of the Advisers Act.[40]

The Advisers Act exempts brokers that engage in certain activities from registering as RIAs. Brokers do not need to register as RIAs if the payments they receive outside of commissions are (1) solely incidental and (2) not special compensation.[41]

First, "solely incidental" means advice rendered and "in connection with and reasonably related to the brokerage services

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35 *See* 15 U.S.C. § 80b-3(a).

36 *See generally id.* §§ 80b-1 to -21.

37 Form ADV is the form used by investment advisers to register with the SEC and their state authority. SEC, *Form ADV*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/glossary/form-adv#:~:text=Form%20ADV%20is%20the%20uniform,Public%20Disclosure%20(IAPD)%20website [https://perma.cc/U8KW-4U6D] (last visited Oct. 16, 2022).

38 *See* SEC Books and Records Rule, 17 C.F.R. § 275.204-2 (2023).

39 *See Information for Newly-Registered Investment Advisers*, SEC, https://www.sec.gov/divisions/investment/advoverview.htm [https://perma.cc/7UW4-6AVP] (last visited Nov. 23, 2010).

40 *See* INV. ADVISER REGUL. OFF. DIV. OF INV. MGMT., SEC, REGULATION OF INVESTMENT ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION 26 (2013), https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf [https://perma.cc/HDX7-KHPS].

41 15 U.S.C. § 80b-2(a)(11)(C).

provided."[42] For research payment purposes, this means that if brokers want to avoid RIA status, the research payments must be solely incidental to the services provided and the payments must not be special compensation. Bundled payments are solely incidental and do not trigger the registration requirement under the Act. Bundled payments for research are considered solely incidental because they are not a separate payment for a service.[43] An SEC interpretive release states that "a broker or dealer provides investment advice that is *not* solely incidental . . . if the broker or dealer charges a separate fee or separately contracts for advisory services."[44] An individual payment from an investor for research would not be solely incidental because it is separate, so the broker would no longer fall under the exemption.[45]

The second part of the test also requires that the broker not receive "special compensation," which is anything outside of commissions, markups, and markdowns.[46] The broker may only accept commission payments, markups, or markdowns if they do not want to be subject to the RIA's regulatory regime.[47] If a broker were to accept a payment for research and execution of a trade that was bundled into one commission, this would not be special compensation, and the broker would not need to register as an RIA. In sum, when accepting payments for research, accepting only payments that are solely incidental and are not special compensation obviates brokers from having to register as RIAs.

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[42] Certain Broker-Dealers Deemed Not To Be Investment Advisers, 70 Fed. Reg. 20424, 20427 (Apr. 19, 2005) (to be codified at 17 C.F.R. pt. 275).

[43] *Id.* at 20428 n.38.

[44] *Id.* at 20424 (emphasis added).

[45] *Payment for Research*, CFA INST. (Nov. 1, 2019), https://www.cfainstitute.org/en/advocacy/issues/payment-investment-research#sort=%40pubbrowsedate%20descending [https://perma.cc/GRX8-DM6L].

[46] INV. ADVISER REGUL. OFF. DIV. OF INV. MGMT., *supra* note 40, at 5 (citing 15 U.S.C § 80b-2(a)(11)(C)). *See also id.* n.22 (quoting S. Rep. No. 76-1775 at 22; H.R. Rep. No. 76-2639 at 28) ("[T]he term 'investment adviser' was 'so defined as specifically to exclude . . . brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions.'")).

[47] *Id.* at 5; SEC, *Markups*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/glossary/markups#:~:text=When%20acting%20in%20a%20principal,difference%20is%20called%20a%20markdown [https://perma.cc/XX9G-MDKM] (last visited Sept. 16, 2023) ("When acting in a principal capacity the broker-dealer generally will be compensated by selling the security to you at a price that is higher than the market price (the difference is called a markup), or by buying the security from you at a price that is lower than the market price (the difference is called a markdown).").

3. *Jurisdictional Challenges for Broker-Dealers*

The current system of having various schemes regulating brokers all over the world begs the question: who is under US jurisdiction? If brokers are only operating in Europe, then the US Advisers Act does not concern them. However, it is difficult to determine who is under the SEC's, and thereby the Advisers Act's, jurisdiction, because the act's jurisdictional reach is very ambiguous. Therefore, whether a group is subject to both jurisdictions is ill-defined, and those that are unsure where they stand will be inclined to comply with both bodies of law rather than take their chances.

Foreign brokers may fall under the Advisers Act's jurisdiction in a variety of ways. When in doubt, brokers should seek No-Action relief from the SEC to clarify the issue.[48] First, a foreign broker could be subject to the Adviser's Act when their actions involve conduct in the United States or have effects in the United States.[49] The SEC has stated that conduct that has or intends to have a substantial effect in the United States is under its jurisdiction.[50] Using mail or other "instrumentalities" of US interstate commerce could also subject the broker to US jurisdiction.[51] Second, when US RIAs have affiliates in foreign countries, this could subject the affiliates to RIA registration as well.[52] This is a complicated area of the law, and determining if foreign brokers are subject to the Advisers Act is beyond the scope of this Comment. It should be noted, however, that the uncertainty clouding the Advisers Act's jurisdiction means that when the two bodies of law conflict, it could be unclear to some firms if they are exposing themselves to the risk of an enforcement action or not.

4. *Regulations for Managers*

Managers' involvement complicates these transactions even further. Brokers can either execute trades for an investor directly or for a manager that reports to a group of investors. When a manager pays a

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48 *See* Seth Chertok, *A Comprehensive Guide to Title IV of the Dodd-Frank Act and the Rules Promulgated Thereunder*, 12 U.C. DAVIS BUS. L.J. 125, 135–38 (2012).

49 The National Mutual Group, 1993 SEC No-Act LEXIS 384, *4 (March 8, 1993).

50 Chertok, *supra* note 48, at 135.

51 *Id.*

52 *Id.* at 136.

broker, the manager has a fiduciary duty to their investors.[53] If the manager does not obtain the lowest commission possible for their investor client, they could be accused of violating their fiduciary duties.[54] A bundled commission means that the fee for executing the trade and the research fee are combined. When charging the increased fee for the research and commission, the manager would not be obtaining the lowest price available from the broker on behalf of the client, and this could violate their fiduciary duty to the investors. To make the bundled approach work, the SEC and Congress had to resolve the problem of managers possibly being in violation of their fiduciary duties.

To remedy managers' potential violations of their fiduciary duties, Congress added Section 28(e) of the Securities and Exchange Act of 1934 in 1975.[55] Section 28(e) is a "safe harbor" because it allows money managers to "pay more than the lowest available brokerage commission rate" for brokerage and research services if the transaction meets certain conditions.[56] If it does not meet the conditions, then the manager is not in the safe harbor, and the manager could be in violation of their fiduciary duties.

There are three conditions that a manager must meet to be within the safe harbor. The conditions of the safe harbor are that (1) a manager must have investment discretion over the account, (2) the commission increase must be used by the manager to pay for brokerage and research services, and (3) there must be a good faith determination by the manager that the value of the services provided for the fee are reasonable in relation to the amount of commission paid.[57] The first condition means that the person to whom the exception applies is the person who decides that securities are purchased and sold.[58] The second condition demonstrates the scope of the safe harbor. The safe harbor *only* applies to commissions for brokerage and research services provided by the broker. Finally, the third condition, the "good faith" requirement, is the most essential part of the safe harbor. The first and second conditions of the safe harbor can be

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[53] THOMAS P. LEMKE & GERALD T. LINS, SOFT DOLLARS AND OTHER TRADING ACTIVITIES, SOFT DOLLARS § 4:1, Westlaw (database updated November 2022).

[54] *Id.*

[55] *See* Interpretive Release Concerning the Scope of Section 28(e) of the Securities and Exchange Act of 1934 and Related Matters, Exchange Act Release No. 34-23170, 51 Fed. Reg. 16004, 16004 (Apr. 28, 1986) (to be codified at 17 C.F.R. pt. 241).

[56] LEMKE & LINS, *supra* note 53.

[57] 15 U.S.C. § 78bb(e)(1).

[58] LEMKE & LINS, *supra* note 53, § 4:2.

ascertained through objective facts about how the broker-dealer relationship is structured, but the good faith requirement is an examination of the choice to pay a commission at a higher rate in exchange for additional research services.

Information, once it is known by the manager, has the potential to benefit more than one of the accounts that the manager manages. For example, broker-dealer "A" might pay for a meeting with an expert on the clean energy sector, because the manager's account, "B," consists of many investments in the clean energy sector. Broker-dealer A will meet with the clean energy expert and gain the expert's opinion about where the industry is going. The manager paid for this conversation to benefit account B, but the manager might have other accounts that have clean energy investments. The "good faith" third condition of the 28(e) safe harbor does not require that the commission increase must contribute information to only one account or transaction. Instead, it can benefit a particular transaction, account, or the manager's overall responsibility for the accounts over which they exercise investment discretion.[59] Thus, the manager's purchase for account B could benefit other accounts that they have with broker-dealer A. The commission increase goes towards research purchases. The broker-dealer is charging the bundled fee by trade, but the difference between the actual cost and the charged commission is what pays for research over time. The safe harbor's limitation is that the increase the manager is paying in commission to the broker-dealer for the research must be reasonable in comparison to the research received in exchange.[60]

The standard for the manager to determine if they have satisfied the good faith determination is ambiguous. Both a subjective belief and business judgment standard have been suggested.[61] The subjective belief standard is when the manager believes the fees paid are reasonable.[62] In contrast, the business judgment standard is when the manager uses reasonable judgment and care of a similarly situated money manager to determine if the manager is within the safe harbor.[63] The SEC has left the most essential part of the safe harbor test fairly ambiguous.

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[59] *Id.*

[60] *Id.* § 4:1.

[61] *Id.* § 4:31.

[62] *Id.*

[63] *Id.*

C. BROKER RESEARCH REGULATIONS IN THE EUROPEAN UNION

In contrast to the United States, the European Union approached the research payment issue with the aim of increasing investor transparency. The European Union encourages completely unbundled research payments. MiFID, or the Markets in Financial Instruments Directive, was originally implemented in 2007 to encourage a more integrated financial market between EU member countries.[64] MiFID II is a revision of MiFID, and it improved investor protections from the original directive.[65] Today, MiFID II is the EU's main financial market regulation directive and ensures one market for investment activities and services.[66]

One of MiFID II's major components is its approach to regulating research payments. MiFID regulates research payments from the "buy side," or manager's side, rather than the broker's side. In other words, MiFID regulates research through what the managers may not purchase (bundled payments), rather than telling broker dealers what they may not offer. MiFID II prohibits bundled commissions on the grounds that the bundled commission would be a prohibited inducement.[67] Inducement means that there is a benefit to the manager in connection with the services provided to the client.[68] Not all inducements are prohibited. Inducements are prohibited when there are benefits to managers in connection to the provision of services to the client, and these benefits do not actually enhance the quality of service to the client.[69] Bundling research could benefit the manager's other accounts in connection with services to the client, so they would be an inducement to the manager. MiFID II prohibits this type of inducement because bundling the commission with research payments would not enhance the quality of service to the client.

Rather than investors paying for research that is "bundled" in commissions, research under MiFID II must either (1) come from a

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64 *Id.* § 11:2.

65 *Policy Activities: MiFID II*, ESMA, https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir [https://perma.cc/L267-NKDR] (last visited Oct. 12, 2022).

66 *Id.*

67 *See generally MiFID II Supplement*, *supra* note 6, art. 13.

68 Mahoney, *supra* note 3, at 2184–85.

69 *MiFID II Supplement*, *supra* note 6, at 503; Council Directive 2014/65, of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments and Amending Directive 2002/92/EC and Directive 2011/61/EU, 2014 O.J. (L 173) 349, 406 [hereinafter *MiFID II*] ("[Investment firms shall] not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients.").

general research budget or (2) come from a research payment account (RPA) to avoid a prohibited inducement.[70] The first option, a general research budget, is straightforward. Rather than charge clients' accounts individually for research, the manager pays for research out of their own resources,[71] and the firm absorbs the costs of whatever research they purchase.

The second option is opening an RPA. The RPA must be operated by the investment firm and is subject to the following conditions: (1) the payment account must be funded by a specific charge to the client, (2) the firm must set and regularly assess a budget for the RPA, (3) the firm is responsible for the RPA, and (4) the firm must regularly assess the quality of the research purchased.[72] RPAs require additional disclosures to the client. First, before supplying any investment services, the manager must disclose the budgeted amount for research and the estimated charges for each research item.[73] After the manager begins giving investment advice, the manager must provide annual information on the total research cost incurred each year.[74]

Interestingly, while RPA charges cannot relate to specific trades or transactions to keep with the unbundled approach,[75] this requirement is still satisfied even if not collected separately from a transaction commission.[76] A manager could purchase research and a security from a broker in a single transaction—as long as the costs of the research and the commission are clearly distinguished and the payment is not linked to the volume or value of the transactions (i.e., by percentage or by the volume of the purchase).[77] Each client gets a separate research charge from the RPA. One RPA can cover multiple accounts, and the RPA can only be used for research.[78]

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[70] *MiFID II Supplement*, *supra* note 6, art. 13.

[71] Joseph Ninan, *The Research Revolution: Investment Research Rules in the Era of MiFID II*, 36 J. INT'L BANKING & FIN. L. 1, 1 (2018).

[72] *MiFID II Supplement*, *supra* note 6, at 516.

[73] *Id.*

[74] *Id.*

[75] Ninan, *supra* note 71, at 4.

[76] *MiFID II Supplement*, *supra* note 6, at 516.

[77] *Id.*; William Yonge & Steven W. Stone, *EU's New Regime on Payments for Research, Use of Dealing Commissions*, MORGAN LEWIS (Apr. 3, 2017), https://www.morganlewis.com/pubs/2017/04/eus-new-regime-on-payments-for-research-use-of-dealing-commissions [https://perma.cc/2GDG-NCPG].

[78] Ninan, *supra* note 71, at 4.

The two approaches to regulating research payments in the United States and the European Union are discordant. The United States' regulations focus on shielding brokers from increased disclosure requirements of the RIA, at the expense of requiring managers to fit into a "safe harbor" to not breach their fiduciary duties. As a result, the investor must pay a general research fee bundled with commission without disclosing the purpose of the fee to the customer. The EU has taken a different approach. The regulations aim to create more transparency for customers at the expense of managers' increased documentation requirements.

II. THE CONFLICT BETWEEN MIFID II AND THE SEC

Which approach to regulating research payments is better: the European Union's or the United States'? It depends on whether "better" is better for the customer, or better for the broker-dealer. The crux of the dispute is who the law should protect, and why. US law currently protects brokers at the expense of decreased investor information, and increased regulation for managers. The European Union's laws protect investors at the expense of increased regulation for managers.

The United States' and the European Union's approaches to regulating purchases of research are in direct conflict with each other, and studies have shown that the United States is mistaken in its bundled approach.[79] The United States chose to wait to address the conflict, pending results of MiFID II on the European market. In the meantime, the SEC issued multiple No-Action letters to stay making its decision.[80] However, in July 2022, the SEC announced it would allow the initial No-Action letter and its subsequent extensions to expire in July 2023, without citing a plan to address the conflicting law.[81] Now that the letter has expired, the two bodies of law continue to conflict.

The effect on the research market after the implementation of MiFID II is in its early stages of study. However, the initial studies on its impact have consistently expressed that MiFID II has made the research

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[79] *See, e.g.,* Yifeng Guo & Lira Mota, *Should Information be Sold Separately? Evidence from MiFID II*, 142 J. FIN. ECON. 97, 99 (2021).

[80] Securities Industry and Financial Markets Association, SEC Staff No-Action Letter, [2002-Current Transfer Binder] Fed. Sec. L. Rep. ¶ 78,603 (CCH) (Oct. 26, 2017) [hereinafter *SIFMA No-Action Letter*].

[81] Birdthistle, *supra* note 11.

market more efficient by increasing the quality of research provided while decreasing the quantity.

The SEC was created to protect investors and ensure efficient markets. As the results of MiFID II's "experiment" in unbundling emerge, these results should be all the SEC needs to change its approach to research payment regulation to attain its agency goals. To do otherwise would conflict with its mission.

A. THE CONFLICT BETWEEN THE ADVISERS ACT AND MIFID II

Before MiFID II took effect in 2018, the SEC issued the Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (2017 SEC No-Act. Lexis 351), in 2017 (SIFMA No-Action Letter). The SIFMA No-Action Letter stated the SEC would not enforce registration as an RIA against a broker-dealer that used an RPA or paid out of their own funds in compliance with MiFID II.[82] Essentially, this letter built a temporary bridge between MiFID II and the SEC's requirements. Broker-dealers under US and EU jurisdiction could comply with MiFID II without being compelled to become an RIA in the United States.

The SEC's No-Action letters are an important publication used to guide the public on gray areas of securities law, specifically stating what the SEC considers actionable. The SEC writes No-Action letters when a person or an entity raises a question about potential violations of securities law.[83] The SEC staff responds to the letter, sometimes granting no action. A No-Action letter means that the SEC would not recommend enforcing the law against them in this circumstance.[84] Sometimes, the no action is extended beyond the requesting party.[85] In the case of the SIFMA No-Action Letter, the no action protection was extended to broker-dealers that provide research services to managers as required by MiFID II.[86]

Initially, the SIFMA No-Action Letter's protections extended for thirty months from the date of the letter, which would have expired in July 2020. In November of 2019, the SEC decided to extend the letter for three

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[82] *SIFMA No-Action Letter*, *supra* note 80.

[83] SEC, *No Action Letters*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/glossary/no-action-letters [https://perma.cc/8VGE-K2WF] (last visited Oct. 26, 2022).

[84] *Id.*

[85] *Id.*

[86] *SIFMA No-Action Letter*, *supra* note 80.

more years, until July 2023.[87] The SEC Chairman cited ongoing monitoring of the impact of MiFID II and the focus on investor choice as the reason for the extension. There were also concerns about modifications to MiFID II after its initial rollout.[88]

Finally, in July 2022, William Birdthistle, the director of the Division of Investment Management at the SEC, stated that the SIFMA No-Action Letter would not be extended again.[89] His speech emphasized the temporary nature of the letter, and that its purpose was to allow broker-dealers to continue business while the SEC decided on its approach. He stated that the SEC researched the issue and that "firms have developed a variety of solutions to address the impact of MiFID II: some broker-dealers have dually registered as investment advisers and others utilize a registered adviser affiliate to provide certain research services."[90] It is unclear from this statement if the SEC is ever going to provide a regulatory change or solution regarding MiFID II. However, the SEC should not use the fact that some firms independently found makeshift solutions as the reason why a regulatory solution should not be provided for all.

The previous understanding in the industry was that the No-Action letter would be extended until the SEC had decided how they wanted to proceed—but the SEC has not changed its position or announced what it plans to do, and the letter has expired.[91] Certainly, the SEC does not have an obligation to regulate this issue. However, since the conflict between MiFID II and the SEC's policies is so vast, the expectation was that the agency would act.

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[87] Press Release, SEC, SEC Announces Extension of Temporary Measure to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions (Nov. 4, 2019), https://www.sec.gov/news/press-release/2019-229 [https://perma.cc/29YR-P9DE].

[88] *Id.*

[89] Birdthistle, *supra* note 11.

[90] *Id.*

[91] The purpose of the no-action relief was to give the SEC time to understand business practices after the implementation if MiFID II, and for members of the industry to evaluate the impacts on their business models. *See* Julian Rainero et. al., *Cross-Border Implementation of MiFID II Research Provisions*, HEDGE FUND J. (Oct. 2017), https://thehedgefundjournal.com/cross-border-implementation-of-mifid-ii-research-provisions/ [https://perma.cc/856M-DU2S]. As a result, the SEC will better be able to assess the impact of MiFID II on the marketplace and act accordingly. *Id.*

B. UNBUNDLING SHOULD BE PERMITTED IN THE UNITED STATES

Until July 2023, broker-dealers under both US and EU jurisdiction could comply with both US and EU requirements. Now that the letter has expired, broker-dealers cannot comply with MiFID II's requirements of unbundling without being potentially penalized for unbundling in the United States with an enforcement action to register as an RIA.

Considering the uncertainty of who is under the jurisdiction of the Advisers Act, and the oppositional nature of MiFID II and the Advisers Act, the United States should still resolve the conflict. It would benefit European brokers if the approach to research payments were consistent, so they know they are complying with both jurisdictions. Granted, ease for European brokers is just an added benefit for the unbundled approach in the United States, and it should not be the aim of SEC reform. Rather, the SEC should change its approach because its current approach does not support investor transparency and favors a system of research that is market inefficient.

To resolve the conflict between the United States and European Union, the SEC should permit voluntary unbundling. Unbundling is the more transparent approach, and brokers should not fear an enforcement action from the SEC for simply trying to be more transparent with investors.[92] The unbundled approach is more transparent for investors because it allows them to see what they bought. This level of transparency also protects against abuse. Through the results of MiFID II, the unbundled approach has also been shown to create a more efficient research market.

This section will first outline the results of MiFID II's unbundled approach, arguing that the European research market is more efficient and the research received is higher quality as a result. Next, this section will discuss the practical realities of allowing the unbundled approach in the United States.

MiFID II took effect in the European Union in 2018. This means that the first research on how MiFID II impacted the research market is just emerging. The results of the research generally focus on a few topics: market consolidation, the quality of the research, and concerns with small and medium enterprises (SMEs).

Firstly, after MiFID II, research shows that the market has consolidated. There are fewer research analysts covering each firm, the

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[92] *See* Mahoney, *supra* note 3, at 2183.

amount of research available has diminished,[93] and research budgets after MiFID II have decreased.[94] One large study examined EU firms after MiFID II and used US firms as a control group to understand the effects of unbundling on analyst coverage of firms. The study found there was a 7.6 percent decrease in analyst coverage, which equates to a reduction of about 8.7 to 7.8 analysts per firm.[95] By comparison, there was a small decrease in US analyst coverage.[96] This decrease in EU coverage was attributed to market consolidation after MiFID II's implementation. Additionally, this study examined where this decrease was coming from: large companies or SMEs? The study found the decrease in coverage came from larger enterprises. The study attributes this change to market competition—large firms only want to purchase research that has large value. SMEs, on the other hand, have fewer resources.[97] The study claims that after MiFID II, SMEs' previous practice of only buying essential research meant their practices did not differ as much after MiFID II because they had fewer resources to begin with.[98] The largest firms generally made the largest reductions in their budgets by percentage.[99]

Secondly, the research available after MiFID II is higher quality.[100] This result seems to demonstrate that when investors are given a bill, or firms must pay for research themselves, they become more selective.[101] To illustrate why this occurred, imagine you go for dinner at a steakhouse. You order your main dish, and the waiter tells you it comes with three sides. You peruse the menu and decide on the side dishes that sound best to you. The check comes, and your dinner costs one hundred

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[93] Guo & Mota, *supra* note 79, at 98.

[94] *Implementing MiFID II – Multi-Firm Review of Research Unbundling Reforms*, FIN. CONDUCT AUTH. (Sept. 19, 2019), https://www.fca.org.uk/publications/multi-firm-reviews/implementing-mifid-ii-multi-firm-review-research-unbundling-reforms [https://perma.cc/4D3M-6SX5].

[95] Guo & Mota, *supra* note 79, at 105.

[96] *Id.*

[97] *See id.* at 107.

[98] *See id.*

[99] RHODRI PREECE, CFA INSTITUTE, MIFID II: ONE YEAR ON, at i, iv (2019), https://rpc.cfainstitute.org/-/media/documents/survey/cfa-mifid-II-survey-report.pdf [https://perma.cc/FBN5-KXEL] ("Although the survey finds an average 6.3% decrease in research budgets, it also finds that budget reductions increase with firm size: for firms managing more than €250 billion in assets, the average budget reduction is 11%; for firms managing less than €1 billion in assets, the budget change is negligible.").

[100] Guo & Mota, *supra* note 79, at 102.

[101] *See* ADRIEN AMZALLAG ET AL., MIFID II RESEARCH UNBUNDLING—FIRST EVIDENCE, ESMA REPORT ON TRENDS, RISKS & VULNERABILITIES 81–83 (2020), https://www.esma.europa.eu/sites/default/files/trv_2020_2-mifid_ii_research_unbundling_first_evidence.pdf [https://perma.cc/VCZ5-Q3PU].

dollars. A few months later, you return to the same steakhouse. The main dish you ordered last time is cheaper, but the sides are now à la carte. You think: do I really need three sides like last time? You end up choosing one side, but it's something you really enjoy. The meal ends up costing you eighty-five dollars. If you ordered the same items as last time, the meal would have cost one hundred dollars.

What happened here? When having to bear the individual cost of items rather than pay one inclusive price, we become more particular, both in the number of items we choose, and the quality of those items. Under MiFID II, brokers either had to charge the cost of their research to the firms or charge it to the client in an RPA. Since research is now offered "à la carte," the brokers are likely more mindful of their choices. As a result, the brokers select less research overall, and the research they do choose is higher quality.

MiFID II fosters competition in the research market. After MiFID II's implementation, an analyst that cannot provide high quality research receives less business, because firms are choosing their research more carefully and consolidating their research purchases from analysts. Since there are fewer research analysts covering each firm, this has incentivized the analysts to provide better research to their customers so they can continue to keep their business.[102] To attract clients and keep them, analysts have to compete in the quality domain because firms are now shouldering costs or transparently passing them on to customers.[103] Previously, research could be charged to the customer without listing what the research charge had purchased. Now, the person receiving the bill is either internal to the brokerage (and thus more likely to ask questions) or is an investor that is given more information about their purchase. Overall, brokerage firms have largely chosen to absorb research costs themselves rather than open an RPA because then the purchase can benefit whatever accounts the firm would like.[104] Given this information, it makes sense that MiFID II has incentivized analysts to perform better.

The decline in analysts could be seen as decreasing competition because it has consolidated the research market and provided fewer options for managers. Studies have not yet shown if the decrease in analysts has consolidated to the point where there is no meaningful choice

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[102] *See* Guo & Mota, *supra* note 79, at 102.
[103] *Id.* at 98.
[104] PREECE, *supra* note 99, at 6.

between research firms.[105] Instead, the decrease in analyst coverage post-MiFID II is attributed to the correction of an oversaturated market of available research.[106]

Finally, before MiFID II was implemented, there was concern on how the directive would affect SMEs. The concern came from the belief that SMEs generally had to "cross-subsidize" their research between accounts.[107] As a reminder, research information, once known, can benefit multiple accounts. Because SMEs were charging investors generally rather than itemizing, experts thought that SMEs were relying on this lack of disclosure to have enough research to go around.[108] However, after MiFID II's implementation, this criticism has been largely unfounded. Compared to large firms, SMEs' research quality and quantity has not declined.[109]

Still, the European Union's implementation of MiFID II has not been perfect. The United Kingdom's exit from the European Union has led to a review of the United Kingdom's financial laws passed under EU directives. This review, called the Edinburgh Reforms, aims to simplify the United Kingdom's financial landscape to poise its financial sector for new growth.[110] One of the areas to be examined is the United Kingdom's implementation of MiFID II unbundling.[111] However, critics say that MiFID II's unbundling requirement has already impacted the UK research market, and repealing the requirement would be "ineffectual" because consumers will expect the same level of transparency even if the law requiring transparency no longer exists.[112] The news of the United Kingdom's review and possible repeal of MiFID II's unbundling provision

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[105] *See* Guo & Mota, *supra* note 79, at 118 (asking "Will the sell-side research markets begin to consolidate? . . . We leave these important questions to future research.").

[106] *See* AMZALLAG ET AL., *supra* note 101, at 81–82 (stating that a concern with bundled research is an excessive amount of low-quality research on the market).

[107] "Cross subsidization" in this context means research information benefitting multiple accounts; one research payment can overlap and benefit other accounts because of the information gained. *See* Guo & Mota, *supra* note 79, at 97.

[108] *See* AMZALLAG ET AL., *supra* note 101, at 5.

[109] *Id.* at 6.

[110] HM Treasury, *Financial Services: The Edinburgh Reforms*, GOV.UK (Dec. 9, 2022), https://www.gov.uk/government/collections/financial-services-the-edinburgh-reforms [https://perma.cc/5DAE-T3P3].

[111] David Wighton & David Ricketts, *Fund Managers Question 'Ineffectual' MiFID II Unbundling Review: 'Everyone has moved on'*, FIN. NEWS (Dec. 16, 2022), https://www.fnlondon.com/articles/fund-managers-question-ineffectual-mifid-ii-unbundling-review-everyone-has-moved-on-20221216 [https://perma.cc/8C63-5LW2].

[112] *Id.*

demonstrates that the legal landscape can change at any time, and customer expectations sometimes trump the lack of legal requirement.

In sum, the results of MiFID II demonstrate that the European Union's research market has become more efficient and transparent without bundling. This occurred because without bundling, brokers were incentivized to cut wasteful or unhelpful research spending. MiFID II also did not put small and medium brokerage firms at the disadvantage that experts had originally expected. Altogether, MiFID II has had a positive impact on the broker research industry because of the incentive to cut wasteful spending and become more transparent.

III. CHANGING THE RESEARCH PAYMENT LAW IN THE UNITED STATES

If the unbundled approach is better, the pertinent question becomes how to change the law in the United States. This Comment will examine the best avenues for changing the law, and the strongest arguments for changing the United States' approach.

Changing the law to the unbundled approach is practically quite difficult, but not impossible. There are two reasons why the United States should embrace the unbundled approach. First, carving out an exception for unbundled payments would align better with the SEC's mission statement. The SEC was created to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.[113] The United States' current bundled approach opposes all of these aims and should be changed to align with the agency's mission. Second, the unbundled approach makes it more difficult for broker-dealers and managers to commit fraud.

A. HOW TO PRACTICALLY CHANGE THE LAW IN THE UNITED STATES

Recall, the SEC extended its No-Action letter to continue to monitor the impact of MiFID II in 2019, before it considered altering its current approach.[114] Since 2019, MiFID II has continued to have a positive

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[113] SEC, AGENCY AND MISSION INFORMATION 4 (2014), https://www.sec.gov/about/reports/sec-fy2014-agency-mission-information.pdf [https://perma.cc/MZE3-FJ7G].

[114] *See* Press Release, SEC, SEC Announces Extension of Temporary Measure to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions (Nov. 4, 2019), https://www.sec.gov/news/press-release/2019-229 [https://perma.cc/E9R8-RJ6K].

impact on both investors and the research market as a whole. It has not been as positive for firms providing research because the market has consolidated.[115] Brokers also have had to bear more costs, opting to absorb costs rather than open RPAs for clients. Rather than taking this as a signal to begin assessing its policy, the SEC announced it was letting its No-Action letter expire for all because some firms had found solutions to the conflict. In other words, since 2019, even in the face of even more conclusively positive data for the unbundled approach, the SEC has stopped indicating it will act.

Why might the SEC not want to follow in MiFID II's success? The most pessimistic view would be that the SEC is protecting brokers and research analysts rather than investors. MiFID II's approach to research payments takes a solidly pro-investor approach because it unbundles payments to improve investor transparency, but it's unlikely, though, that the SEC is intentionally putting investors at a disadvantage. It is more likely that the SEC's measures of solving past research payment problems has created a web of complex legislation that is difficult to change.

Previously, for the bundled approach to work in the United States, the SEC has added provisions to protect brokers from registering as RIAs,[116] and for managers to not violate their fiduciary duties to investors.[117] The distinction between broker-dealers and RIAs, for example, has been in place since 1940.[118] Since then, different bodies of law have governed the standards of conduct for brokers and RIAs. Broker-dealers are regulated mainly by FINRA and specific SEC rules and regulations.[119] Meanwhile, RIAs are governed almost exclusively through the Advisers Act and SEC regulations.[120] RIAs are also fiduciaries to their customers, whereas broker-dealers are not (with some exceptions).[121] First, the separation between broker-dealers and RIAs has been heavily regulated for almost eighty years, which is why solving the unbundled payments and enforcement action issue is so difficult. Legislative history

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[115] *See* PREECE, *supra* note 99, at iv.

[116] *See* 15 U.S.C. § 80b-2(a)(11)(C).

[117] *See* Interpretive Release Concerning the Scope of Section 28(e) of the Securities and Exchange Act of 1934 and Related Matters, Exchange Act Release No. 34-23170, 51 Fed. Reg. 16004, 16007 (Apr. 28, 1986) (to be codified at 17 C.F.R. pt. 241).

[118] *See generally* 15 U.S.C. § 80b-3.

[119] SEC, STUDY ON INVESTMENT ADVISERS AND BROKER DEALERS 106 (2011), https://www.sec.gov/news/studies/2011/913studyfinal.pdf [https://perma.cc/4XYQ-QL6T].

[120] *Id.*

[121] *Id.*

around the act indicates that broker-dealers were excluded from its regulations because they were already subject to the Securities and Exchange Act of 1934, enacted six years earlier.[122] Second, to make matters more complicated, the 28(e) safe harbor has also had a long history of regulating and clarifying that managers must not breach fiduciary duties to their clients.[123] To switch to the unbundled approach, this framework would have to be repealed or further regulated.

Repealing versus regulating has different costs and benefits. Repealing the framework would take an act of Congress, as both unbundling provisions are laws in either the Investment Advisers Act or the Securities and Exchange Act. The likelihood that these sections could be repealed and replaced is low. Repealing would allow the research payment issue to be approached anew and more clearly outline new rules. The other option, regulation, would be more convoluted for investors to understand, but could more easily be achieved.

Experts have mostly suggested changing US policy through regulation rather than repeal. This requires using the existing legal infrastructure to allow unbundling. Rather than passing a new law, definitions could be changed, or words could be interpreted differently.

One suggestion is that the SEC should promulgate a rule to modify the definition of special compensation to exclude unbundled payments.[124] As a reminder, the current definition considers unbundled payments to be special compensation because they are outside of commissions. If the term "special compensation" explicitly excluded research payments, either through a modification of Section 28(e), or through an SEC interpretation of the rule, then brokers under US and EU jurisdictions could comply with both laws.[125]

Critics could argue the change is unnecessary. If brokers choose to offer unbundled payments, they are not prohibited from doing so under US law, but they could be required to register as an RIA depending on their assets under management. While this argument is constructively

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[122] Certain Broker-Dealers Deemed Not to Be Investment Advisers, 70 Fed. Reg. 20424, 20428 (Apr. 19, 2005) (to be codified at 17 C.F.R. pt. 275).

[123] *See* Brian T. Daly & Marc E. Elovitz, *SEC Confirmation on "Soft Dollars" Safe Harbour*, HEDGE FUND J. (Nov. 2013), https://thehedgefundjournal.com/sec-confirmation-on-soft-dollars-safe-harbour/#:~:text=e)%20Safe%20Harbor-,Section%2028(e)%20of%20the%20Securities%20Exchange%20Act%20of%201934,eligible%20brokerage%20and%20research%20services [https://perma.cc/EE2W-LXMT].

[124] Mahoney, *supra* note 3, at 2191.

[125] *Id.*

valid, the practical realities of the current law should be considered. It is true that broker-dealers could simply register as RIAs when necessary, but there are two problems with this approach. First, by requiring brokers to register, the SEC is essentially prohibiting unbundling because no firm wants to subject itself to RIA requirements. Second, this approach conflicts with the SEC's mission statement.

Currently, if brokers offer unbundled research payments, they must be vigilant over the amount of assets under their management to know when to register.[126] Registration requires additional costs, such as employee education and additional disclosures and forms.[127] This is an additional monitoring and monetary cost the firm must bear, driving up the cost of operations. Some of these increased costs inevitably would pass onto customers. This constructive prohibition of unbundled payments must change for US law to harmonize with MiFID II.

B. Current Law is Not Aligned with the SEC's Mission Statement

Congress formed the SEC to increase investor transparency after the 1929 stock market crash that caused the Great Depression.[128] Today, the SEC's acquiescence to brokers' actions directly opposes its mission statement. The SEC must allow the unbundled approach unequivocally to protect investors, ensure efficient markets, and facilitate capital formation.

1. *The Investor Protection Requirement*

The first part of the SEC's mission is to protect investors.[129] This protection requires disclosures of financial information and enforcing

[126] Registration is prohibited at lower amounts of assets under management (AUM). Mark P. Cussen, *Becoming a Registered Investment Adviser (RIA)*, INVESTOPEDIA (May 22, 2023), https://www.investopedia.com/articles/professionals/041013/becoming-registered-investment-advisor.asp#citation-1 [https://perma.cc/3LBL-8J99]. At higher levels of AUM ($110 million) registration is required. *Id.* Between these two extremes, there is a "buffer zone" where registration becomes optional. *Id.*

[127] Those that want to be an RIA must take the Series 65 exam, administered by FINRA. *Id.* The firm must register after a certain level of assets under management and submit disclosures through form ADV each year. *Id.*

[128] SEC, *The Role of the SEC*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/role-sec [https://perma.cc/D4QN-YDU9] (last visited Mar. 7, 2023).

[129] *Id.*

securities laws.[130] This way, investors know they have updated and accurate information when making an investment decision.

In contrast, the bundled approach does not protect investors; it encourages less transparency and is not in line with the SEC's mission. The evidence emerging from MiFID II's implementation shows that the unbundled approach better protects investors because managers can no longer charge general research fees; instead they must attribute specific research charges to the fund. One of MiFID II's goals in unbundling was to increase investor transparency.[131] It is difficult to imagine how bundling could fulfill the SEC's mission.

The United States currently uses the bundled approach, which is not as transparent as the unbundled approach. The bundled approach combines all research payments into one single fee, so information about what was purchased is not accessible. Transparency is "characterized by visibility or accessibility of information especially concerning business practices."[132] The unbundled approach by design allows investors to see, line by line, what they are paying for—it is far more transparent.

One could argue that the bundled approach provides some transparency, although not as much as the unbundled approach. Another alternative that would be even less transparent would be simply increasing fees without any mention of or information on why the increase occurred. However, the SEC's mission does not just encourage investor protection; it must actively strive to protect investors through its rules. The 1929 stock market crash occurred in large part because brokers were not required to disclose if they were offering investors good investments. As a result, Congress created the SEC to make transparent disclosures a requirement. Unbundling is the option that best adheres to the SEC's investor protection requirement because it is the most transparent.

2. *The Efficient Markets Requirement*

The second part of the SEC's mission is to ensure efficient markets. The SEC's laws and regulations need to reflect what payment structures are actually being used in the industry to effectively regulate and require relevant disclosures. This requires a balancing act between

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[130] *See id.*

[131] Guo & Mota, *supra* note 79, at 98.

[132] *Transparent*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/transparent [https://perma.cc/U8RF-96TJ] (last visited Jan. 3, 2023).

maintaining the status quo and changing its approach in light of market developments.[133]

MiFID II's approach to research payments is a market development. Since its implementation, it has made the research market more efficient. For the SEC to ensure efficient markets, it should embrace the EU's approach.

MiFID II's implementation has increased the quality of research purchased on the market, but it has also decreased the quantity.[134] As a result of MiFID II, the EU's research market is becoming more efficient, not less. MiFID II incentivized brokers to decide what research they actually need and cut unnecessary spending, resulting in an overall decrease in research purchases. With the knowledge that MiFID II has created a more efficient research market, the SEC must do the same to align with its efficient markets mission.

Not considering bundled commissions to be "special compensation" was the wrong approach from the beginning, because it does not ensure efficient markets per the SEC's mission.[135] After all, for managers to uphold their fiduciary duties, the SEC had to create a safe harbor for managers that allowed them to decline the lowest price on commissions. The SEC created the safe harbor to help brokers bundle research payments, not to help investors. The efficient approach would be to allow unbundled commissions. As the results of MiFID II in the European Union have shown, doing so leads brokers to cut wasteful spending and research firms to provide better research products.

3. The Facilitating Capital Formation Requirement

Finally, the SEC's mission embraces facilitating capital formation. The agency aims to make rules that make it easier for entrepreneurs to access capital.[136] For research payment unbundling, this

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[133] *See Mission*, *supra* note 16.

[134] Guo & Mota, *supra* note 79, at 102.

[135] Brokers do not need to register as Registered Investment Advisers if the commissions they receive are solely incidental and *not* special compensation. 15 U.S.C. § 80b-2(a)(11)(C). An interpretive release by the SEC classified bundled research payments as solely incidental when bundled or combined with the regular brokerage fee. Certain Broker-Dealers Deemed Not To Be Investment Advisers, 70 Fed. Reg. 20424, 20424–31 (Apr. 19, 2005) (to be codified at 17 C.F.R. pt. 275). Bundled commissions are not special compensation because they are commission payments. INV. ADVISER REGUL. OFF. DIV. OF INV. MGMT., *supra* note 40, at 5; *Markups*, *supra* note 47.

[136] *Mission*, *supra* note 16.

means that the SEC's rules should encourage investment firms to invest in small businesses, not the opposite.

First, facilitating capital formation means that brokers should be encouraged to invest in small businesses. Making informed investment decisions requires research. An unbundled research payment would disclose more information to the client. Second, if firms paid for the research out of their own pockets (as has become popular in the European Union after MiFID II) it would allow the firm to utilize the information about the small businesses in other parts of its business, since the firm owns it. If research does not end up benefiting one account, it has the potential to benefit another.

In conclusion, the SEC should encourage practices that facilitate capital formation. Its rules should aim to protect investors, not brokers or managers. And its rules should support the most market-efficient result. Unbundling research payments supports all three facets of the SEC's mission and should be embraced.

C. Current Law in the United States Enables Fraud

The current bundled approach in the United States makes it easier for brokers to commit fraud or misuse funds. The unbundled approach requires more disclosures and thereby makes it more difficult to misuse funds.

It is easy for brokers to hide behind bundled commissions to misappropriate funds. So long as payments fit within the 28(e) safe harbor, they are permitted.[137] Brokers are given considerable discretion when using investors' money, and with this level of discretion comes the potential for fraud. To fall under the 28(e) safe harbor, the following conditions must exist: (1) the manager must have investment discretion over the account, (2) the commission increase must be used by the manager to pay for brokerage and research services, and (3) there must be a good faith determination by the manager that the value of the services provided for the fee are reasonable in relation to the amount of commission paid.[138] The good faith determination that the fee for services is reasonable does not have a clear test. Legal scholars have suggested two tests: the subjective belief and business judgment standard.[139]

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[137] Lemke & Lins, *supra* note 53.
[138] 15 U.S.C. § 78bb(e).
[139] Lemke & Lins, *supra* note 53, § 4:31.

Neither the subjective belief test nor the business judgment standard provide clear answers to brokers on what behavior is prohibited and clearly constitutes misuse. The business judgment standard means that the manager must use reasonable judgment and care that a "similarly situated money manager would use."[140] A subjective belief test means that the standard of care for the manager would be based on their own actions. The subjective belief of the manager would have to be that the research is proportional compared to the amount paid.[141] When managers possess this much discretion to determine what is "reasonable," they can abuse their clients' trust. Research payments, which fall under the umbrella of "soft dollars,"[142] could be used to enrich the manager rather than pay for research. Brokers must disclose soft dollar use on Form ADV, which is available to the public, but the form requires no disclosures about how soft dollars are actually used by the firms.[143] Over the years, there have been some shocking cases involving diversion of soft dollar funds, such as managers using these funds for their own marital settlement agreements, rent payments, and favors.[144] On its face, the 28(e) safe harbor does not allow soft dollars to be diverted for personal use. However, because the law requires (1) very little disclosure about actual soft dollar use in Form ADV and (2) a reasonability standard in the 28(e) safe harbor, proper use of the 28(e) safe harbor is hard to enforce, which makes fraud harder to detect.

Unbundling commissions has the potential to reduce the misuse of investor funds. It is true that brokers could simply label fees as research purchased, but executing this type of fraud would require an affirmative disclosure. Most firms under MiFID II do not charge the client for research

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[140] *Id.*

[141] *Id.*

[142] Soft dollars are a general term for when brokerage firms are paid for their services through commission, rather than paying for their management fee separately. James Chen, *Soft Dollars: Definition, Arrangement Examples, vs. Hard Dollars*, INVESTOPEDIA (Mar. 31, 2021), https://www.investopedia.com/terms/s/softdollars.asp [https://perma.cc/HL3L-TZPH]. Bundled research payments are a type of soft dollar payment, because the management fee pays for research payments. *Id.*

[143] Form ADV Part 1A asks if soft dollars are used by the firm and if their use falls into the 28(e) Safe Harbor. *See Form ADV*, SEC, https://www.sec.gov/about/forms/formadv-part1a.pdf [https://perma.cc/J2VL-N4UN] (last visited Jan. 5, 2023). *See also* Brendan Biffany, Note, *Fixing Soft Dollars is Not That Hard: A Consent and Reporting Framework for Regulating Client Commission Arrangements*, 68 DUKE L.J. 141, 156–57 (2018).

[144] *See* Biffany, *supra* note 142, at 156–58 (explaining that the SEC has found advisers do not provide meaningful disclosures to clients and cites multiple examples of improper soft dollar use discovered by the SEC).

directly; instead, they absorb the cost. If a broker diverted funds for their own personal use, they would be liable to their employer in most cases because they would be diverting the employer's money rather than the client's.

In summary, the United States should permit MiFID II's unbundled approach. The law should protect investors over broker-dealers. The current approach in the United States for research payments protects broker-dealers' interests over the investors, in contravention of the SEC's core mission. Research on the effects of unbundled research payments has shown that many concerns about unbundling are largely unfounded. Instead, its benefits of greater transparency to the investor and greater efficiency in the research market make it a better option than the bundled approach. If the SEC is to protect investors, ensure efficient markets, facilitate capital formation, and decrease the likelihood of fraud, the unbundled approach is the best approach to research payment.

IV. CONCLUSION

The United States should permit broker-dealers to charge for research separately without triggering an enforcement action. The SEC's temporary No-Action letter expired in July 2023, and now only bundled commissions are permitted in the United States. To allow bundled commissions in the United States in the first place, a complex set of laws were required to authorize them for both broker-dealers and managers. In contrast, the unbundled approach would not require safe harbor legislation for managers but would require a change of existing law for broker-dealers to ensure they are not subject to an enforcement action. Research has shown that the unbundled approach is better for the market and for investors.