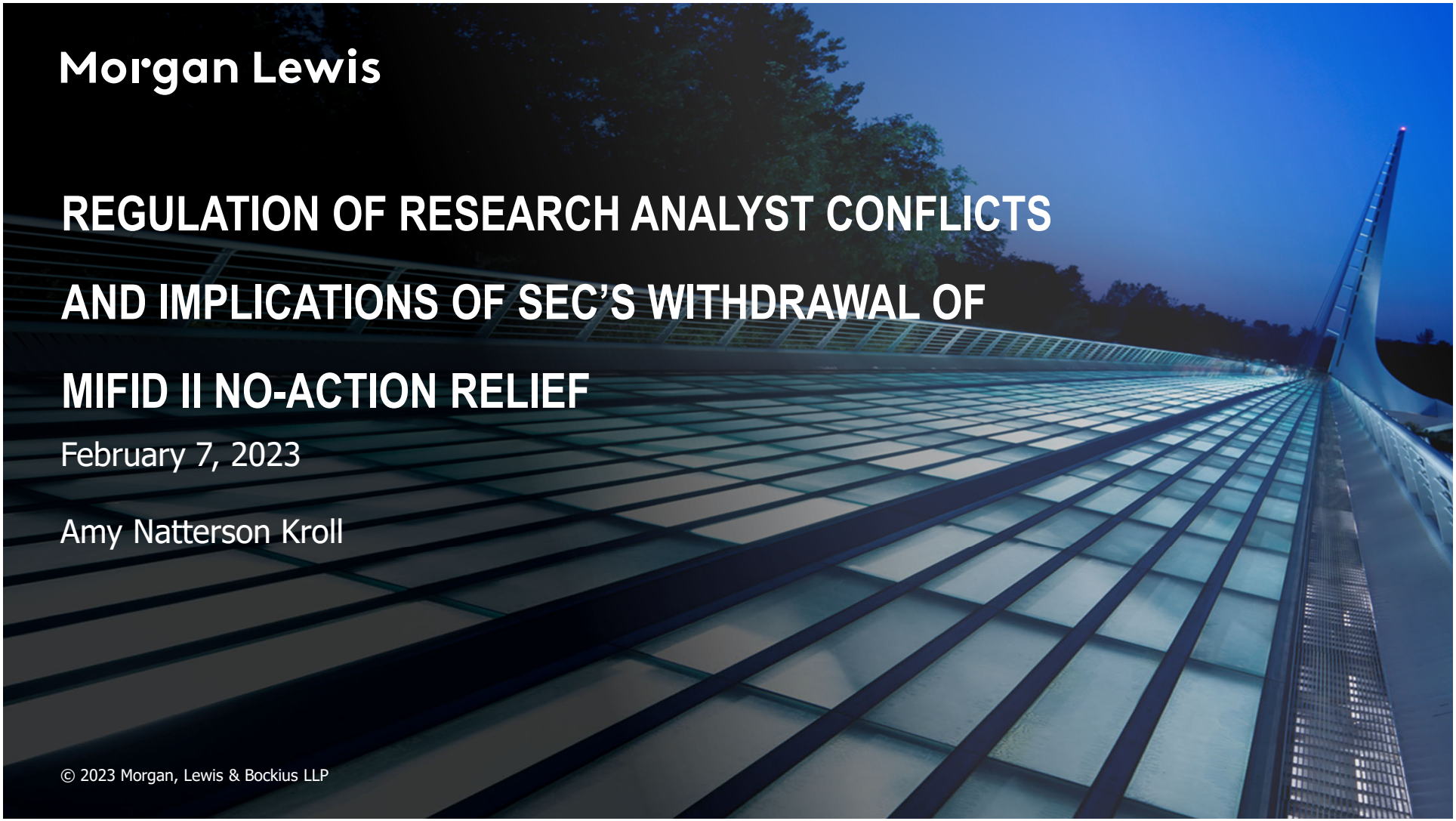

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REGULATION OF RESEARCH ANALYST CONFLICTS AND IMPLICATIONS OF SEC'S WITHDRAWAL OF MIFID II NO-ACTION RELIEF

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TIMELINE OF REGULATION OF RESEARCH ANALYST CONFLICTS

- **1999-2002 – SEC Begins to Examine Research Analyst Conflicts**
  - SEC begins to focus on research analyst conflicts due to concern that analysts were not disclosing their own conflicts of interest.
  - SEC examinations of large firms revealed, among other things:
    - conflicts such as:
      - Analyst compensation based on profitability of their investment banking units, and
      - investment banker involvement in evaluating/determining compensation of research analysts.
  - NASD and NYSE engage in rulemaking to address research analyst conflicts of interest.
- **2002 – Sarbanes-Oxley Act**
  - Required SEC, and NASD/NYSE at the SEC's direction, to engage in rulemaking to address research analyst conflicts.
- **2003 – Regulation Analyst Certification (Reg AC)**
  - Requires research analyst to certify in their research reports that views expressed are their own, and
  - Whether their compensation was, is, or will be related to any specific recommendations or views expressed in the report.
- **2003 – Global Research Settlement**
  - SEC and other regulators enforcement action against largest investment banks for engaging in practices that resulted in inappropriate influence by investment banking over equity research analysts, creating conflicts of interest that the firms failed to adequately manage.
  - Required that the firms insulate research analysts from investment banking personnel, including physical separation and communication firewalls, among others.
- **2010 – Global Research Settlement Modification**
  - Certain limitations imposed by the settlement were terminated based on SRO (NYSE and FINRA rules) provided similar protections. However, requested modification to the communication firewall term was not granted.
- **2012 – JOBS Act**
  - Lifted certain constraints on research analysts in connection with emerging growth companies (EGCs). EGCs have annual gross revenue of less than $1.07 billion (based on current indexing). They retain EGC status until (1) annual gross revenue is $1.07 billion or more, (2) for the first five years after first sale of registered common equity, (3) until three years after issuing more than $1 billion in convertible debt, or (4) on the date on which the issuer is deemed a large accelerated filer.

TIMELINE OF MiFID II DEVELOPMENTS

- **2014 – MiFID II Announced**
  - A package of reforms and amendments to the existing Markets in Financial Instruments Directive, establishing the framework for regulation of financial markets and securities across the EU.
- **2017 – MiFID II Rules Went Into Effect**
  - Including those pertaining to payment for investment research.
- **2017/2019 – SIFMA No-Action Relief**
  - In 2017 the SEC took a temporary no-action position providing relief for asset managers subject to MiFID II pertaining to acceptance of certain types of payment for research (discussed in more detail on the next slides). This relief was set to expire in July 2020.
  - In 2019, the SEC extended the position to July 3, 2023.
- **2022 – SEC Announced Expiration of SIFMA No-Action Relief**
  - The Director of the Division of Investment Management announced in a speech that the Division would allow the no-action relief to expire on July 3, 2023, stating that firms have developed solutions to address the impact of MiFID II.

PAYMENT FOR RESEARCH UNDER MiFID II

- MiFID II requires portfolio managers to pay for "inducements", which include research, by:
  - (1) direct payments from portfolio managers out of their own resources (hard dollars), or
  - (2) payments from a separate research payment account (RPA) funded by payments for research by the portfolio manager's clients.
- In the context of research, unbundling was designed to increase transparency of research and execution costs, by addressing potential conflicts of interest associated with money managers tying research-buying decisions with execution decisions.
- Studies have shown that
  - The unbundling of research costs under MiFID II has resulted in asset managers paying for research from their own resources rather than impose new charges specifically for research on their clients.
  - Post-MiFID II implementation, many asset managers decreased their research budgets and number of their research providers (this downward trend appears to have begun prior to MiFID II).
  - There has been an increased trend toward asset managers insourcing research.
  - Trends suggest that analysts are covering some issuers in less depth or not at all as research resources are being scaled back and focused on larger names with greater trading activity.
  - Small issuers are less likely than large issuers to be covered by research and the availability of research coverage and number of analysts covering an issuer correlate with market capitalization.
    - Factors potentially contributing to this, in addition to MiFID II, include regulations designed to address analyst conflicts, a decline in IPOs until 2020, fewer institutional investors investing in small issuers, increased reliance on in-house research, among others.
- In addition, there has been an increase of small issuers paying for research analyst coverage, which has been identified as a consequence of MiFID II, raising conflict of interest concerns with respect to such issuer-sponsored research.
- In 2021, the European Commission adopted amendments to MiFID II permitting bundled (soft dollar) commission payments for research on small- and mid-cap issuers as part of the EU's COVID recovery strategy. The goal was to incentivize the provision of research to small- and mid-cap issuers in an effort to support the recovery of European businesses. Also in 2021, the UK regulator Financial Conduct Authority (FCA) adopted exemptions from MiFID II's inducement rules for research on small and medium-sized enterprises.

IMPACT OF WITHDRAWAL OF SIFMA NO-ACTION RELIEF ON RESEARCH COVERAGE OF SMALL COMPANIES

- The acceptance of unbundled payments for research raises investment adviser status issues for U.S. broker-dealers because a broker-dealer is excluded from the definition of "investment adviser" under the Investment Advisers Act as long as
  - (1) its provision of investment advice (investment research) is "solely incidental" to its business as a broker-dealer, and
  - (2) it receives no "special compensation" for that advice.
- Hard dollar payments for research can constitute "special compensation," causing a broker-dealer that accepts such payment for research to risk triggering investment adviser status.
- The SIFMA no-action relief allows broker-dealers to accept research payments in hard dollars from money managers subject to MiFID II without triggering investment adviser status. With the withdrawal of the letter, broker-dealers will be unable to accept hard dollars for research deemed investment advice on securities without risking investment adviser status.
- With broker-dealers unable or unwilling to accept hard dollars for research, there is concern that broker-dealers will be even less incentivized to provide research on the smallest public companies if their research is not supported by commission fees. This could result in money managers not being able to obtain necessary research on small issuers that might benefit their advised accounts.

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Amy Natterson Kroll counsels financial institutions on US regulatory requirements and best practices related to broker and dealer activities. Amy advises clients on issues related to the implementation of new regulations; acquisition and sale of broker-dealers; expansion of business and related regulatory requirements for financial institutions; and regulations related to capital markets, such as research activities and research analysts, participation in public offerings, supervisory controls and internal controls, and cross-border securities activities. Amy also advises clients on activities involving digital assets and delivering financial services through web-based and other electronic means.

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Asia Pacific
Europe
Latin America
Middle East
North America

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Almaty
Beijing
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong
Houston
London
Los Angeles
Miami
New York
Nur-Sultan
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San Francisco
Seattle
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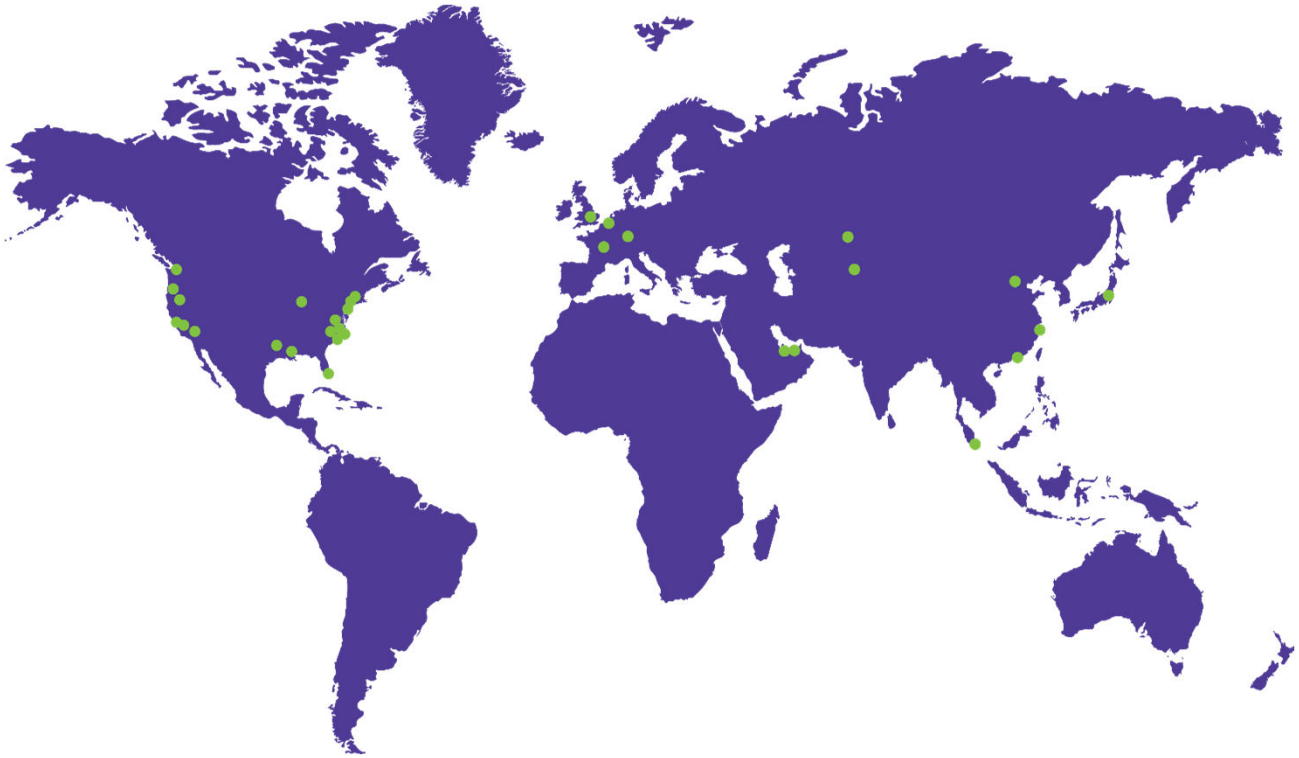
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



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THANK YOU

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