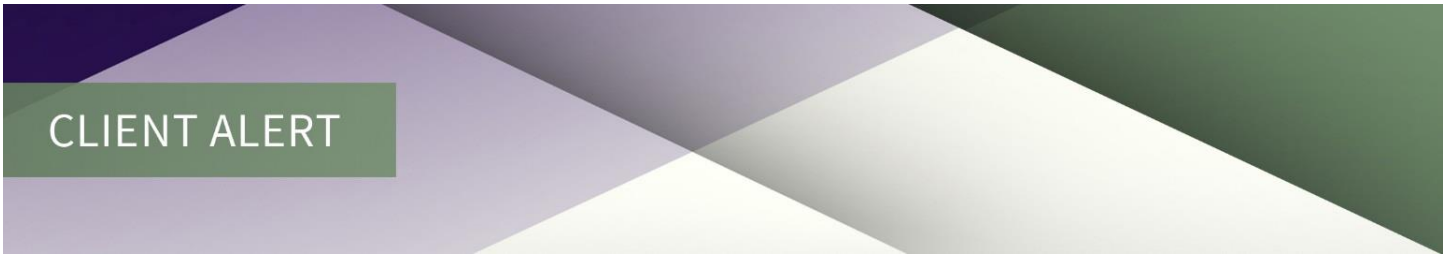

No-Action Relief to Facilitate Cross-Border Implementation of MiFID II Research Provisions

November 17, 2017

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The SEC staff issued three no-action letters on October 26, 2017 providing relief to investment advisers, registered investment companies and broker-dealers to grant "greater certainty regarding their U.S.-regulated activities as they engage in efforts to comply" with the European Union's (EU) Markets in Financial Instruments Directive (MiFID II).[1] The no-action letters provide the following relief, subject to the conditions described in the letters and summarized in more detail below:

> *For registered investment companies and investment advisers*.[2] Allows investment advisers to aggregate securities orders for clients when execution costs differ solely due to payments for research.[3]

1 *See* SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions (Oct. 26, 2017), Press Release at https://www.sec.gov/news/press-release/2017-200-0.

2 *See* Investment Company Institute, Division of Investment Management SEC No-Action Letter (Oct. 26, 2017) (the ICI Letter). *See* https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm.

3 Footnote 6 in the ICI Letter issued on October 26, 2017 limits this relief to investment advisers that are subject to MiFID II (either directly or contractually). We understand that the SEC staff has indicated that the footnote will be modified to clarify that the relief would be available to all investment advisers, provided that the additional payment relates to research only, and the reason for the differing amounts is due to aggregation of trades requiring compliance with MiFID II with those that do not.

For registered broker-dealers and foreign broker-dealers operating under Rule 15a-6 under the Securities Exchange Act of 1934 (Exchange Act).[4] Allows such broker-dealers to receive direct payments (i.e., "hard dollars") for research services[5] from investment managers subject to MiFID II and sub-advisers of MiFID II advisers, who are contractually bound to comply with MiFID II, without causing the broker-dealer to be regulated as an investment adviser under the Advisers Act.

For money managers using client assets under a MiFID II-compliant research payment account (RPA) to pay for research.[6] Allows payment by a money manager for research through an RPA, funded with client money, to qualify for the safe harbor under Section 28(e).

Background

Fiduciary principles in the U.S. and the EU require money managers to seek "best execution" for client trades and restrict the ability of money managers to use client assets for their own benefit.[7] Recognizing the value of research to clients, Congress enacted Section 28(e) of the Exchange Act to provide a safe harbor to protect money managers from liability for a breach of fiduciary duty solely on the basis that they paid more than a lower commission rate in order to receive "brokerage and research services" provided by a broker-dealer if the conditions of the safe harbor are met. Section 28(e) preempts other fiduciary and related laws addressing conflicts of interest between money managers and their clients, including the fiduciary provisions of the Employee Retirement Income Securities Act of 1974 (ERISA), the provisions of Section 17 of the Investment Company Act of 1940 (Investment Company Act) and the anti-fraud provisions of Section 206 of the Advisers Act. The Section 28(e) safe harbor has facilitated the provision of research by broker-dealers through commissions rather than direct payments (commonly referred to as "soft dollars"), and has allowed broker-dealers that provide research, that is deemed to be investment advice, to rely on an exclusion in the Advisers Act from the definition of "investment adviser."[8]

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4 *See* Securities Industry and Financial Markets Association, Division of Investment Management SEC No-Action Letter (Oct. 26, 2017) (the SIFMA Letter). *See* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm.

5 "Research services" covers all content and related services that could constitute "research" under MiFID II and be considered "investment advice" under the U.S. Investment Advisers Act of 1940 (Advisers Act), including, without limitation, research reports, research models, sales and trading commentary, trading ideas, and interaction with research analysts and other broker-dealer personnel.

6 *See* Securities Industry and Financial Markets Association, Division of Trading and Markets SEC No-Action Letter (Oct. 26, 2017) (the AMG Letter). *See* https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf.

7 *See, e.g.*, Commission Guidance Regarding Client Commission Practice Under Section 28(e) of the Securities Exchange Act of 1934, SEC Rel. No. 34-54165 (July 18, 2006).

8 Section 202(a)(11)(C) of the Advisers Act excludes from the definition of "investment adviser" "any broker or dealer whose performance of such [investment advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." The exclusion has been interpreted to treat client commission payments for research services as not being "special compensation" and to treat investment advice provided through the research as being "solely incidental" to the broker-dealer's conduct of its brokerage business.

The EU, in adopting MiFID II, took a substantially different approach in addressing the same fiduciary and conflict of interest concerns that prompted Section 28(e). MiFID II prohibits investment managers from receiving or retaining "inducements" in connection with the conduct of their business. "Inducements" include a wide range of monetary and non-monetary benefits, including research. Payments for research are not considered to be unlawful inducements if the investment manager pays for the research (i) directly out of its own resources, (ii) with client approval, through an RPA funded by client money based on a research budget or (iii) a combination of the two.[9] The EU requirements created a dilemma for U.S. broker-dealers providing research, because receipt by them of a direct, hard dollar, payment could subject them to regulation in the U.S. as an investment adviser. In addition, investment advisers that are subject to MiFID II and elect, with the required client consent, to use the RPA as a method to pay for research, could find themselves without the necessary relief to operate under U.S. law (including ERISA, the Investment Company Act and the Advisers Act) because it is unclear whether the RPA would satisfy the requirements to rely on the safe harbor in Section 28(e).

In light of the conflicts between the two regimes and the difficulty of complying with both, U.S. investment advisers, registered investment companies and broker-dealers sought relief from the SEC staff. As noted in the SEC's press release, the no-action relief was designed to "take a measured approach" in order to allow firms to comply with MiFID II "while respecting the existing U.S. regulatory structure."[10] The no-action letters provide limited relief as follows:

(i) Division of Investment Management No-Action Relief – ICI Letter.

The ICI Letter provides relief under Section 17(d) of the Investment Company Act, Rule 17d-1 thereunder and Section 206 of the Advisers Act to enable an investment adviser to aggregate orders for the sale or purchase of securities on behalf of clients in reliance on the position taken in the SMC Capital No-Action Letter despite different transaction costs.[11] Under the SMC Capital No-Action Letter, an investment adviser may aggregate client orders if the adviser adopts procedures designed to prevent clients from being disadvantaged by the aggregation of orders and, among other things, transaction costs of the aggregated orders are shared *pro rata* based on each client's participation in the transaction.[12] Because MiFID II prohibits use of bundled client commissions to pay for research by investment advisers subject to MiFID II, without relief, it was not clear that investment advisers would be able to aggregate the orders of clients of investment advisers subject to MiFID II with orders of clients of U.S. investment advisers that may pay for research through commissions under Section 28(e).

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9 *See* Commission Delegated Directive Supplementing the MiFID II Directive, Art. 13.1 (Apr. 7, 2016) at http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf.

10 SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions, SEC Press Release (Oct. 26, 2017).

11 *SMC Capital, Inc.*, SEC Staff Letter (Sept. 5, 1995).

12 *See also Pretzel & Stouffer*, SEC Staff Letter (Dec. 1, 1995) (providing that aggregated orders are permitted only if consistent with an adviser's duty to seek best execution and to treat all clients fairly).

The ICI Letter indicates that client orders may be aggregated even though subject to differing arrangements regarding the payment for research that will be required by MiFID II, subject to the following:

- Each client in an aggregated order pays or receives the same average price for the purchase or sale of the underlying security and pays the same amount for execution; and
- Each investment adviser relying on the relief adopts policies and procedures reasonably designed to ensure that (1) each client in an aggregated order pays the average price for the security and the same cost of execution (measured by rate), (2) the payment for research in connection with the aggregated order will be consistent with each applicable jurisdiction's regulatory requirements and disclosures to the client, and (3) subsequent allocation of such trade will conform to the adviser's allocation statement and/or the adviser's allocation procedures.

Footnote 6 in the response letter states that the relief is limited to investment advisers that are subject to MiFID II directly or by contract (e.g., sub-advisers of an EU-regulated adviser). However, we understand that the SEC staff has indicated that they will re-issue the ICI Letter to clarify that advisers that are not subject to MiFID II may rely on the relief for trades that are aggregated across client accounts that are subject to MiFID II and those that are not, provided that the differences in transaction costs associated with the aggregated trades are attributable solely to varying research arrangements due to the implementation of MiFID II.

(ii) Division of Investment Management No-Action Relief – SIFMA Letter.

The SIFMA Letter provides relief to allow registered broker-dealers and foreign unregistered broker-dealers operating pursuant to Rule 15a-6 under the Exchange Act to accept direct, "hard dollar" payments for research services that constitute investment advice under the Advisers Act without becoming subject to the definition of "investment adviser" under the Advisers Act. Under this relief, the hard dollar payments may only be from EU investment managers directly subject to MiFID II and non-EU advisers who are contractually required by an EU investment manager to comply with MiFID II, for example, under a sub-advisory agreement. Under the SIFMA Letter, payments to the broker-dealer may be made (i) by the investment adviser from its own funds, (ii) from an RPA funded with money from the adviser's clients, or (iii) a combination of the two.[13]

The SIFMA Letter provides the relief for 30 months from MiFID II's implementation date,[14] during which time the staff notes that it intends to "monitor and assess the impact of MiFID II's requirements on the research marketplace and affected participants in order to ascertain whether more tailored or different action is necessary."[15]

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[13] We are aware some investment managers and their clients are arranging for their clients to be invoiced directly by research providers.

[14] Assuming that the implementation date for MiFID II is not delayed, the relief would lapse after July 3, 2020.

[15] SIFMA Letter, fn. 6.

(iii) Division of Trading and Markets No-Action Relief – AMG Letter.

The AMG Letter permits money managers to use RPAs to make research payments in a manner that is consistent with current client commission sharing models under Section 28(e) and to ensure that those payments, which are not made through commissions but are made alongside payments for execution, qualify for protection under the Section 28(e) safe harbor, subject to the following conditions:

- The operation of the RPA would be the same as a commission sharing arrangement (CSA) except that (i) the amount paid for research would be identified separately from the amount paid for execution before the money manager makes the payments to the executing broker-dealer and (ii) the RPA would be under the control of the money manager, who is responsible for the RPA;
- The executing broker-dealer would be contractually required to collect research payments alongside payments for execution made by the money manager out of client assets and pay the amounts into the RPA;
- The money manager would make payments to the executing broker-dealer out of client assets for research alongside payments to that executing broker-dealer for execution;
- The research services paid through the RPA would be eligible for the safe harbor under Section 28(e);
- The executing broker-dealer would effect the securities transaction; and
- The executing broker-dealer would be contractually required by the money manager to pay for research through the use of an RPA in connection with a CSA.

The relief provided in respect to the RPA does not by its terms limit its application to investment managers that are subject to MiFID II.

Companion European Guidance

On the same date that the SEC staff issued its no-action letters, the European Commission (the EC) issued frequently asked questions (FAQ) to address industry concerns related to the application of MiFID II.[16] In the first FAQ, the EC confirmed that broker-dealers may receive combined payments for research and execution as a single commission as long as the payment attributable to research can be identified. The EC also stressed the importance of several steps that investment managers subject to MiFID II must take, such as managing an RPA research budget based on a reasonable assessment of the need for such research and subject to appropriate controls, including maintaining a clear audit trail of

[16] *See* MiFID II: Interaction with Third Country Broker-Dealers, Press Release at https://ec.europa.eu/info/system/files/non-eu-brokers-dealers.pdf.

payments made to research providers, and being able to identify, based on an internal allocation/budgeting process with regard to its own clients, the amount spent on research with a particular third country broker-dealer.[17] In the second FAQ, the EC confirmed that broker-dealers will need to identify a separate identifiable charge for research when an investment manager subject to MiFID II pays for these services either out of an RPA or directly out of its own resources. The guidance emphasized that research charges may not be conditioned on levels of payment for execution services.

On the same day, the United Kingdom's Financial Conduct Authority (FCA) commented on the SEC staff's three no-action letters, expressing support for the guidance.[18] The FCA's statement confirms that sharing of research within a buy-side group should be acceptable provided that they do not influence the firm's order routing decisions, execution costs and ability to act in its clients' best interests. The FCA indicated that it plans to continue working with the EC and SEC on implementation of MiFID II across all borders.

Conclusion

The no-action letters provide useful relief to investment advisers, registered investment companies and broker-dealers as they endeavor to comply with the MiFID II research requirements. Notwithstanding the no-action relief, there continue to be a number of compliance and implementation questions that the financial services industry is seeking to resolve before MiFID II takes effect on January 3, 2018. As firms address these issues, execution practices and research delivery processes can be expected to evolve, and firms will need to examine existing agreements with clients and service providers as well as disclosures.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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[17] *Id.*

[18] *See* FCA Statement on MiFID II Inducements and Research, Press Release at https://www.fca.org.uk/news/statements/fca-statement-mifid-ii-inducements-and-research.