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SEC Update

SEC Staff Addresses Cross-Border Implementation of MiFID II Research Provisions

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In response to concerns raised by numerous investment management industry participants, the Securities and Exchange Commission (SEC) Staff issued three letters on October 26, 2017 designed to provide investment advisers, registered investment companies, and broker-dealers "greater certainty regarding their US-regulated activities as they engage in efforts to comply" with the European Union's (EU) Markets in Financial Instruments Directive (MiFID II), effective as of January 3, 2018.[1] This article provides an overview of the conflicts between the US and EU research payment regimes arising from the implementation of MiFID II, and the SEC Staff's "measured approach" enabling firms to comply with MiFID II "while respecting the existing US regulatory structure."[2]

Safe Harbor

Applicable law in the US and the EU requires money managers to seek best execution for client trades and restricts the ability of money managers to use client assets for their own benefit.[3] Recognizing the value of research to clients, the US Congress enacted Section 28(e) of the Securities Exchange Act of 1934 (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 a higher commission rate than otherwise available in seeking 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 Security Act of 1974 (ERISA), as amended, 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 Investment Advisers Act of 1940 (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"), which, in turn, 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."[4]

The EU, in adopting MiFID II, took a substantially different approach in addressing fiduciary and conflict of interest concerns of the sort that prompted Section 28(e). MiFID II prohibits an investment manager from receiving or retaining "inducements" in connection with the conduct of its business. Inducements include a wide range of monetary and non-monetary benefits, including research. Payments for research are not considered to be unlawful inducements, however, if the investment manager pays for the research (i) directly out of its own resources, (ii) with client approval, through a research payment account (RPA) funded by client money based on a research budget, or (iii) a combination of the two.[5]

The EU requirements thus created a dilemma for a US broker-dealer providing research, as the broker-dealer's receipt of a direct, "hard dollar," payment could be seen as subjecting the broker-dealer to regulation in the US as an investment adviser. In addition, an investment adviser that is subject to MiFID II and elects, with the required client consent, to use the RPA as a method to pay for research, could have found itself unable to operate under US law (including ERISA, the Investment Company Act, and the Advisers Act) because of a lack of clarity as to 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, US investment advisers, registered investment companies, and broker-dealers sought clarification from the SEC Staff.

Division of Investment Management Position—ICI Letter[6]

The ICI Letter deals with Section 17(d) of the Investment Company Act, Rule 17d-1 thereunder and Section 206 of the Advisers Act. In reliance on a SEC Staff position with respect to the aggregation of client orders set out in a 1995 letter to SMC Capital, Inc. (the SMC Capital Letter),[7] an investment adviser may aggregate client orders when the adviser adopts procedures designed to prevent clients from being disadvantaged by the aggregation of orders.[8] The SMC Capital Letter contemplated, among other things, that transaction costs of the aggregated orders would be shared *pro rata* based on each client's participation in the transaction. MiFID II, in contrast, prohibits the use of bundled client commissions to pay for research by investment advisers subject to MiFID II. As a result, the adoption of MiFID II created uncertainty as to whether an investment adviser subject to MiFID II could aggregate the orders of MiFID II clients with orders of US clients that may pay for research through commissions under Section 28(e).

In the ICI Letter, the SEC Staff took a no-action position with respect to aggregated client orders that are subject to differing arrangements regarding the payment for research as required by MiFID II, when the following facts are present:

- 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 position adopts policies and procedures reasonably designed to ensure that (i) each client in an aggregated order pays the average price for the security and the same cost of execution (measured by rate), (ii) the payment for research in connection with the aggregated order is consistent with each applicable jurisdiction's regulatory requirements and disclosures to the client, and (iii) subsequent allocation of such trade conforms to the adviser's allocation statement and/or the adviser's allocation procedures.[9]

Division of Investment Management Position—SIFMA Letter[10]

Under the SIFMA Letter, a registered broker-dealer and a foreign unregistered broker-dealer operating pursuant to Rule 15a-6 under the Exchange Act can accept direct, hard dollar, payments for research

services[11] that constitute investment advice for purposes of the Advisers Act without becoming subject to the definition of "investment adviser" under the Advisers Act. The hard dollar payments may only be from an EU investment manager directly subject to MiFID II and a non-EU adviser that is 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.

The SIFMA Letter's position is temporary and expires 30 months from MiFID II's implementation date (that is, July 3, 2020), during which time the SEC Staff 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."[12]

Division of Trading and Markets Position—AMG Letter[13]

Under the AMG Letter, a money manager may use RPAs to make research payments in a manner that is consistent with current client commission sharing models under Section 28(e) and 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. The following factual context must be present:

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

The position taken in the AMG Letter with respect to an RPA does not by its terms limit its application to an investment manager that is subject to MiFID II.

Conclusion

The SEC Staff letters provide useful guidance to investment advisers, registered investment companies, and broker-dealers as they endeavor to comply with the MiFID II research requirements. Notwithstanding the positions expressed in the letters, a number of compliance and implementation questions continue to exist with respect to the US federal securities laws that the financial services industry is seeking to resolve. As firms address these matters, 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.

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NOTES

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 available at *https://www.sec.gov/news/press-release/2017-200-0*.

2 *Id.*

3 *See, e.g.*, *Commission Guidance Regarding Client Commission Practice Under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Release No. 54165 (July 18, 2006).

4 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.

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

6 *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.*

7 SMC Capital, Inc., Division of Investment Management SEC No-Action Letter (Sept. 5, 1995). A key aspect of the SMC Capital Letter was the Staff's view that the mere aggregation of orders for advisory clients, including a 1940 Act-registered investment company, would not violate Section 17(d) when the registered investment company participates on terms no less advantageous than those of any other participant.

8 *Id. See also* Pretzel & Stouffer, Division of Investment Management SEC No-Action Letter (Dec. 1, 1995) (indicating that aggregated orders need to be consistent with an adviser's duty to seek best execution and to treat all clients fairly). The Pretzel & Stouffer letter indicated that procedures other than those set out in the SMC Capital Letter may be used by an investment adviser consistent with Section 17(d) and Section 206.

9 Footnote 6 in the ICI Letter indicates that the letter's position is limited to an investment adviser that is subject to MiFID II directly or by contract. Some industry participants questioned whether this footnote narrows the potential scope of the position. According to the Investment Company Institute, the SEC Staff has clarified and confirmed that the position "is not limited to MiFID II obligated firms. Rather the footnote is intended to communicate that, to rely on the [position] provided in the [ICI Letter], the research costs vary because of compliance with MiFID II requirements (*i.e.*, orders are being aggregated with an adviser that is subject to MiFID II)." ICI Memorandum, Clarification Regarding SEC Relief on Aggregation of Trade Orders in the Context of MiFID II (March 12, 2018).

10 *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.*

11 "Research services" for these purposes covers all content and related services that could constitute research under MiFID II and be considered "investment advice" under the 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. *See* SIFMA Letter at n.5 (referring to research services, which are illustrated in footnote 7 of the incoming letter).

12 SIFMA Letter at n.6.

13 *See* Securities Industry and Financial Markets Association, Asset Management Group, 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.*