ROPES & GRAY

ALERT

Asset Management

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SEC Issues No-Action Letters to Ease U.S. and MiFID II Compliance; EC Issues Guidance on MiFID II Advisers' Receipt of Research from Non-EU Brokers

On October 26, 2017, the SEC staff issued three no-action letters to, respectively, the Investment Company Institute (the "*ICI Letter*"), the Securities Industry and Financial Markets Association's Asset Management Group (the "*SIFMA-AMG Letter*") and SIFMA (the "*SIFMA Letter*"). The three letters provide greater certainty to market participants regarding compliance with U.S. law as they seek to comply with the European Union's updated Markets in Financial Instruments Directive ("MiFID II") by January 3, 2018.

- The *ICI Letter* stated that the SEC staff would not recommend enforcement action if an investment adviser, to satisfy MiFID II requirements, aggregates orders for the purchase or sale of securities on behalf of its clients in a manner that expands upon the order-aggregation requirements in the 1995 SMC Capital, Inc. no-action letter.1 The *ICI Letter* provides assurance with respect to Section 17(d) of the 1940 Act, Rule 17d-1 thereunder and Section 206 of the Advisers Act.
- The *SIFMA-AMG Letter* stated that the SEC staff would not recommend enforcement action if a MiFID II Adviser (as defined below) pays for research from a MiFID II research payment account ("RPA") alongside payments for execution services, in reliance on the safe harbor of Section 28(e) of the Exchange Act. Consistent with the incoming letter, the *SIFMA-AMG Letter* has the effect of confirming that a payment for research from an RPA alongside a separately identified payment for execution are equivalent to a bundled "commission for effecting a securities transaction," and that third-party research paid for from an RPA would be deemed "provided by" the executing broker-dealer, as required by Section 28(e).
- MiFID II requires a MiFID II Adviser to pay for research from the adviser's own resources, an RPA or a combination of the two. The *SIFMA Letter* stated that the SEC staff would not recommend enforcement action if a broker-dealer provides research services that constitute investment advice under section 202(a)(11) of the Advisers Act to a MiFID II Adviser. The *SIFMA Letter* thus permits a broker-dealer to be compensated for providing research to a MiFID II Adviser without the payments being deemed to be "special compensation" under Section 202(a)(11) merely because the payments are made in a manner required by MiFID II. The assurances in the *SIFMA Letter* expire in July 2020.

On the same day that the SEC staff issued the three no-action letters, the European Commission issued guidance to clarify how MiFID II Advisers should deal with non-EU brokers that provide research.

I. Background

MiFID II regulates EU financial markets, EU brokers and securities dealers and some EU investment advisers (each a "MiFID II Adviser"). Some investment advisers are contractually required to comply with MiFID II, as well (each, also, a "MiFID II Adviser") (*e.g.*, a U.S. subadviser to an EU adviser). Beginning January 3, 2018, MiFID II will prohibit MiFID II Advisers from accepting fees, commissions or any monetary or non-monetary benefits (other than minor non-monetary benefits) from any third party in relation to a service provided to a client, on the basis that any such fees, commissions or benefits would be inducements and, therefore, create conflicts of interest between a firm and its clients. Prohibited non-minor, non-monetary benefits include substantive investment research provided to

MiFID II Advisers, provided, however, that investment research provided by third parties to MiFID II Advisers will ***not be regarded as an inducement*** if the investment research is received in return for (i) direct payments from the MiFID II Adviser's own resources, or (ii) payments from an RPA that is funded by each client by means of a research budget that is set, regularly assessed, and agreed upon with the client, or (iii) a combination of the two. A MiFID II Adviser must determine the scope and the cost of the research that it wants to receive from each broker-dealer or other research provider.

The client research charge can be collected directly from the client or can be collected "alongside" a transaction commission, where the MiFID II Adviser directs a trade to a broker-dealer and transmits the "unbundled" research payment with the execution payment, subject to conditions. The execution payment is retained by the broker-dealer, and the broker-dealer remits the research payment to the RPA. The total research payments remitted from a particular transaction to each RPA may vary from client to client (or groups of clients), depending upon each client's research-budget arrangement with the MiFID II Adviser. Thus, while execution costs are unaffected, the total costs of a particular aggregated transaction may vary from client to client (including possibly execution only, if a client has no research budget).

The MiFID II Adviser will use the funds in the RPA to pay for investment research. Multiple clients and their respective RPAs may participate in obtaining specific investment research.

II. The *ICI Letter*

In *SMC Capital*, the SEC staff stated that the mere aggregation of orders for advisory clients, including registered funds and other collective investment vehicles in which the adviser, its principals or employees have an interest, would not violate Section 17(d), Rule 17d-1 thereunder and Section 206, provided, among other things, that each account that participates in an aggregated order participates at the average share price for all transactions by the adviser in that security, with *all transaction costs* shared on a pro rata basis.

In the *ICI Letter*, the SEC staff cited the ICI's statements in its incoming letter that MiFID II requires the separation of execution and research payments, and that a MiFID II Adviser could obtain research from third parties, including executing brokers, that the MiFID II Adviser pays for directly from its own account, an RPA or a combination of the two. As a result of these various potential research arrangements and combinations, contrary to the conditions of *SMC Capital*, clients of MiFID II Advisers may not pay a pro rata share of all transaction costs (*i.e.*, research payments) associated with an aggregated transaction (although the clients would continue to pay the same average security price and execution cost).

The staff noted the ICI's assertion that, unless *SMC Capital* were expanded, MiFID II Advisers could be forced to place competing orders in the same security in the market, raising the possibilities that (i) clients overall would receive poorer execution, and (ii) one group of clients could benefit at the expense of another.

In the *ICI Letter*, the SEC staff stated that it would not recommend enforcement action against a MiFID II Adviser that aggregates orders on behalf of its clients in reliance on *SMC Capital* while accommodating MiFID II's requirements regarding the payment for research, provided certain conditions are satisfied. Specifically, to ensure that orders continue to be aggregated and allocated in a fair and reasonable manner that will not systematically disadvantage any client, MiFID II Advisers must adopt policies and procedures reasonably designed to ensure that:

1. Each client in an aggregated transaction pays the average price for the security and the same cost of execution (measured by rate);

2. A payment for research in connection with the aggregated transaction is consistent with each applicable jurisdiction's regulatory requirements and disclosures to clients; and

3. Subsequent allocations of the aggregated transactions conform to the MiFID II Adviser's "Allocation Statement" and/or allocation procedures. The Allocation Statement is a pre-trade written statement specifying the participating client accounts and the intended allocation among them. If the order is only partially filled, the order is allocated pro rata based on the Allocation Statement.

The ICI's incoming letter contained additional representations on which the *ICI Letter* was based. Therefore, those seeking to rely on the *ICI Letter* should seek to comply with all of the representations (many, but not all, of which are identical to those in *SMC Capital*).

In sum, a MiFID II Adviser that satisfies these conditions may continue to rely on the *SMC Capital* no-action assurances when aggregating transactions for registered investment companies and other clients. The *ICI Letter* applies only to MiFID II Advisers.

III. The *SIFMA-AMG Letter*

Section 28(e) of the Exchange Act provides a safe harbor for liability for violations of law or breach of fiduciary duty for an investment adviser solely by reason of causing a client's account to pay a broker-dealer ***a commission for effecting a securities transaction*** in excess of an execution-only commission rate, if the adviser makes a good faith determination that the amount paid was reasonable in relation to the value of the brokerage and research services ***provided by*** the broker-dealer.

SIFMA-AMG's incoming letter described the existing U.S. model, wherein investment advisers rely on a commission sharing arrangement/client commission arrangement ("CCA") to pay a single "bundled" commission to broker-dealers for order execution, as well as for Section 28(e) eligible research services. The executing broker-dealer credits a portion of the commission for research to a CCA "account" administered by the executing broker-dealer (or third-party aggregator) and retains the remainder of the commission payment.

SIFMA-AMG's incoming letter highlighted that, in a 2006 interpretive release,[2] the SEC addressed the use of CCAs, and stated that, for purposes of Section 28(e), the executing broker "effects the securities transaction" and "provides" the research either by assuming the legal obligation to pay for the research or by performing various tasks, including paying a third-party research preparer directly.

SIFMA-AMG's incoming letter noted that the RPA model is similar to the CCA model but identified two differences between the RPA model and the existing CCA model. First, in the RPA model, the amount paid for research is identified separately from the amount paid for execution ***before*** the adviser makes the commission payments to the executing broker-dealer. Second, the RPA is required to be under the control of the MiFID II Adviser, and the MiFID II Adviser is held responsible for the RPA. These two differences created uncertainty under Section 28(e) and the SEC's 2006 interpretative release. Specifically:

- SIFMA-AMG sought the SEC staff's assurance that a "commission for effecting a securities transaction" for Section 28(e) purposes may include a research component that is separately quantifiable from the execution component at time of trade, as required by MiFID II.
- SIFMA-AMG sought the SEC staff's assurance that in an RPA arrangement, where (i) an executing broker is legally obligated to pay for research by transmitting payments it receives for research into the RPA, and (ii) the use of an RPA requires contractual safeguards to ensure that RPA assets are used only to purchase research for clients, research acquired by payment from the RPA is "provided by" the executing broker for purposes of Section 28(e).

In the *SIFMA-AMG Letter*, the SEC staff cited the incoming letter's statements regarding the operation of CCAs and RPAs. Based on these facts and representations, the SEC staff agreed not to recommend enforcement against a MiFID II Adviser seeking to operate in reliance on Section 28(e) if it pays for research through the use of a MiFID

II-compliant RPA and provided that all other conditions of Section 28(e) are satisfied. The SEC staff highlighted that its position is available only in the following circumstances:

1. The MiFID II Adviser makes payments to the executing broker-dealer out of client assets for research alongside payments to that executing broker-dealer for execution.

2. The research payments are for research services that are eligible for the safe harbor under Section 28(e).

3. The executing broker-dealer effects the securities transaction for purposes of Section 28(e).

4. The executing broker-dealer is legally obligated by contract with the MiFID II Adviser to pay for research through the use of an RPA in connection with a CCA.

IV. The *SIFMA Letter*

Section 202(a)(11)(C) of the Advisers Act excludes from the definition of "investment adviser" a broker-dealer whose performance of any investment advisory services is "solely incidental" to the conduct of its business as a broker or dealer, provided it receives no "special compensation" for those services.

SIFMA's incoming letter noted that in a CCA, following the framework established by the SEC under Section 28(e), an investment adviser pays a ***bundled payment*** for brokerage and research services. In contrast, an RPA is funded through a ***separately identified research charge*** that is assessed under an agreed-upon research budget and imposed on a trade-by-trade basis ***separately*** from trade-by-trade execution charges. In its incoming letter, SIFMA expressed concern that the receipt of payments for research services directly or indirectly out of a MiFID II Adviser's own resources or from an RPA, as required by MiFID II, could subject a broker-dealer to the Advisers Act by undercutting the broker-dealer's ability to rely on the longstanding broker-dealer exclusion in Section 202(a)(11)(C).

In the *SIFMA Letter*, the SEC staff cited SIFMA's concerns that (i) a broker-dealer's receipt of payment for research in the manner required by MiFID II may subject the broker-dealer to regulation under the Advisers Act, and (ii) without no-action assurance, MiFID II could have a negative impact upon broker-dealers generally, given the global nature of U.S. capital markets and the reliance by non-U.S. and global investment advisers on research services provided by broker-dealers. Based on these representations, the SEC staff confirmed that, for thirty months following MiFID II's January 3, 2018 implementation date (*i.e.*, until July 2020), it would not recommend enforcement action if a broker-dealer provides research services that constitute investment advice under Section 202(a)(11) to a MiFID II Adviser that is required to pay for the research services from the MiFID II Adviser's own resources, an RPA or a combination of the two.

In a footnote to the *SIFMA Letter*, the SEC staff stated that the thirty-month period is intended to provide the SEC time to understand the evolution of business practices after MiFID II's January 3, 2018 implementation.

V. European Commission Guidance

On the same day that the SEC staff issued the three no-action letters, the European Commission issued guidance to clarify how MiFID II Advisers should deal with non-EU brokers that provide research. The guidance states that a non-EU broker-dealer may receive combined payments for research and execution as a single commission when providing such services to a MiFID II Adviser, as long as the payment attributable to research can be identified, and there is a clear audit trail of payments to separate research providers. The guidance also confirms that a MiFID II Adviser must identify a separate research charge for research supplied by non-EU broker-dealers. The guidance states that, in the absence of receiving a separate research invoice from the non-EU broker, the MiFID II Adviser may decide to consult with third parties, including the non-EU broker, with a view to determining the charge attributable to the research provided, which charge should not be influenced by levels of payment for execution services.

VI. Discussion

In view of the imminent effective date of MiFID II, the *ICI Letter*, the *SIFMA-AMG Letter* and the *SIFMA Letter* are welcome developments because they reduce U.S. regulatory uncertainty and the possibility of market disruption.

While the three no-action letters facilitate near-term compliance with MiFID II without violating U.S. law, they do not alter the fact that MiFID II and the U.S. federal securities laws are largely inconsistent regimes. For example, MiFID II requires the unbundling of research and execution payments to broker-dealers, while Section 28(e) was enacted with such bundling in mind. In fact, on the same day the three no-actions letters were published, SEC Commissioner Kara M. Stein issued a statement lauding MiFID II because it "will give investors transparency into the cost of both research and trading commissions," and asking if investors otherwise "know of the potential conflicts of bundled payments." Commissioner Stein criticized the three no-action letters because the "staff's no-action relief does not adequately address these issues and merely kicks the can down the road." While "kicking the can down the road" may be a fair characterization of the three no-action letters, it is not apparent that the SEC staff had any good alternatives, given that Section 28(e) was enacted by Congress, and that her predecessor commissioners' 2006 interpretive guidance is binding on the staff. In other words, reconciling MiFID II and U.S. law is not a quick fix because each legal regime is fundamentally inconsistent with the other and, moreover, completely reconciling the two regimes may be beyond the powers of the SEC acting independently.

In the SEC's announcement of the three no-action letters, the SEC stated that the relief is "intended to provide the staff with sufficient time to better understand the evolution of business practices after implementation of the MiFID II research provisions." SEC Chairman Jay Clayton observed that the staff's letters "take a measured approach in an area where the EU has mandated a change in the scope of accepted practice, and accommodate that change without substantially altering the U.S. regulatory approach." This "measured approach" appears to be a good starting point in light of the nearing deadline and the complexity of harmonizing the U.S. and EU regimes. While many questions remain, the three no-action letters address some of the most urgent matters, including preserving MiFID II Advisers' access to U.S. broker-dealer research and third-party research. The no-action letters also give the SEC (and Congress) the opportunity to observe the longer-term effects of unbundling research and execution within the EU and on markets more generally, as they consider additional steps to harmonize the U.S. and MiFID II regimes.

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