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Client Alert

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SEC Issues MiFID II No-Action Relief and Allays Various Cross-Border Concerns

By Matthew R. Silver

On January 3, 2018, the European Union (EU) Markets in Financial Instruments Directive (MiFID II) will require, for impacted EU parties, that research be priced separately from execution. This represents a significant change from the current practice, whereby research is generally supplied as part of a bundle of services, with no explicit charge. Absent new U.S. regulations or other relief, this change had the potential to cause a significant number of problems for U.S. advisers, funds and clients dealing with EU parties. In particular, many of these parties could have lost access to valuable research under MiFID II.

On October 26, 2017, however, the SEC issued three no-action letters designed to provide market participants with greater certainty regarding their U.S. regulated activities as they engage in efforts to comply with MiFID II in advance of the implementation date, in order to accommodate the EU regulated clients and firms they may work with.

The Investment Company Institute (ICI) MiFID II no-action relief (the "1940 Act Letter") focused on the Investment Company Act of 1940 (the "1940 Act") and Rule 17d-1 and Section 206 of the Investment Advisers Act of 1940 (the "Advisers Act"). The two Securities Industry and Financial Markets Association (SIFMA) requests were centered on Section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act") as well as Advisers Act Section 202(a)(11). As a result of these three no-action letters, existing soft-dollar and commission-sharing arrangements may continue, subject to certain new restrictions.

Set forth below is a summary of all three no-action letters.

Relief for Registered Funds and Advisers - the 1940 Act Letter

Under a no-action letter issued to SMC Capital Inc. in 1995 (the "SMC No-Action Letter"), advisers may aggregate orders for securities transactions on behalf of their clients, subject to certain conditions. One of those conditions is that the clients included in the aggregated order must pay the same average price and execution costs. As a result of the various potential research arrangements and combinations thereof resulting from MiFID II, however, impacted clients may not pay (or be able to pay) a *pro rata* share of *all* costs (*i.e.*, research payments) associated with aggregated orders.

Under the 1940 Act Letter, the SEC has provided relief for investment advisers that who aggregate orders for the sale or purchase of securities on behalf of their clients in reliance on the position taken in the SMC No-Action Letter, while still accommodating the differing arrangements regarding the payment for research that will be required byMiFID II. Absent this new relief, advisers might have been forced to place into the market competing orders in the same security, possibly resulting in worse execution for clients overall and the potential to benefit one set of clients at the expense of another.

Specifically, investment advisers may continue to aggregate client orders for purchases and sales of securities, where some clients may pay different amounts for research because of MIFID II requirements – as long as all clients continue to receive the same average price for the security and execution costs.

To rely on the 1940 Act Letter, investment advisers must adopt 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.

Investment Advisers Relief Concerning Section 28(e) Bundled Commissions

Exchange Act Section 28(e)'s safe harbor addresses the manner in which a money manager can use client commissions to purchase "brokerage and research services" without breaching its fiduciary duties to its clients.

Money managers in the U.S. often rely on a client commission arrangement (CCA)[1] structure to pay a single "bundled" commission to broker-dealers for order execution as well as eligible brokerage and research services. The executing broker-dealer credits the portion of the commission for research to a CCA administered by the executing broker-dealer, and retains the remainder

1 In a CCA, the brokerage (including execution) and research portions of the commission are separated at a later point in time, *i.e.*, when the executing broker-dealer retains its payment for brokerage, including execution, and credits or transmits the research payment to the CCA.

of the commission payment. In the alternative, the executing broker-dealer may forward the research portion of the commission to a CCA administered by an external "aggregator" or administrator. Where an external aggregator or administrator is used, the money manager generally instructs the executing broker-dealer to deduct the portion of the commission payment for brokerage, including execution, from payments going to the CCA administered by that third party.

Under MiFID II, the amount paid for research must be identified separately from the amount paid for execution before the money manager makes the payments to the executing broker-dealer, and payment for research services may only be made from the manager's own money, a Research Payment Account (RPA) funded by client money, or some combination of the two. Further, an RPA is required to be under the control of the money manager, and the money manager is held responsible for the RPA.

The SEC's Division of Trading and Markets provided relief to SIFMA ("SIFMA Letter 1") to allow a money manager to operate within the 28(e) safe harbor if the money manager makes payments for research to an executing broker-dealer out of client assets alongside payments for execution through the use of an RPA that conforms to the MiFID II requirements MiFID II. Reliance on relief in SIFMA Letter 1 is conditioned on:

- The money manager making payments to the executing broker-dealer out of client assets for research alongside payments to that executing broker-dealer for execution.
- The payments being made for research services that are eligible for the Section 28(e) safe harbor.
- The executing broker-dealer effecting the securities transaction for purposes of Section 28(e).
- The executing broker-dealer being legally obligated by contract with the money manager to pay for research through the use of an RPA in connection with a CCA.

Temporary Relief to Broker Dealers - Compensation for Research

Broker-dealers were also granted no-action relief under a separate no-action letter issued to SIFMA in connection with Section 202(a)(11)(C) of the Advisers Act ("SIFMA Letter 2"). That section generally excludes broker-dealers from regulation under the Advisers Act as long as they perform investment advisory services that are "solely incidental" to the conduct of their broker-dealer business and receive "no special compensation" for these services. Broker-dealers were concerned, however, that their receipt of research payments, either directly or through an RPA, might be considered "special compensation," thereby subjecting them to regulation under the Advisers Act.[2]

Absent the grant of no-action relief, a broker-dealer could explore providing the "research" component of certain services as an investment adviser (such as through a dedicated division); but for many broker-dealers, doing so would present significant legal and practical challenges – including as a result of potential limitations on agency and principal trading under Section 206(3) of the Advisers Act.

Pursuant to SIFMA Letter 2, a U.S.-regulated broker-dealer may, without being considered by SEC staff to be an "investment adviser," accept separate compensation for research services that constitute investment advice under section 202(a)(11) of the Advisers Act from a money manager that is required under MiFID IIto pay for the research services by using RPAs. This relief is currently set to be in place until 30 months from MiFID II's implementation date (July 3, 2020). The SEC's Division of Investment Management notes that it "may or may not renew [this relief] as appropriate."

Practice Point: *The relief granted under SIFMA Letter 2 does not extend to a U.S. broker-dealer accepting discrete and separate research payments from clients* ***not*** *impacted by MiFID II. The relief granted only relates to the provision of services to investment managers that are required as a result of MiFID II to pay for the research services by using research payments, either directly or by contractual obligation.*

Similarly, as made clear by the SEC staff in the 1940 Act Letter, the position expressed does not apply to an investment adviser that is not subject to MiFID II (either directly or contractually).

2 See the no-action request letter underlying SIFMA Letter 2, in particular page 3 thereof.

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