SEC Issues Three No-Action Letters to Facilitate Cross-Border Implementation of MiFID II's Research Provisions

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On October 26, 2017, the Division of Investment Management and the Division of Trading and Markets of the Securities and Exchange Commission ("**SEC**") issued three related no-action letters (the "**Letters**") to address certain issues raised by cross-border implementation of the European Union's ("**EU**") Markets in Financial Instruments Directive ("**MiFID II**"), which will take effect on January 3, 2018. According to the SEC, the Letters are designed to provide a path for market participants to comply with the research requirements of MiFID II in a manner that is consistent with U.S. federal securities laws.

As further discussed below, MiFID II will require the separation (or "**unbundling**") of execution and research payments made by investment managers to broker-dealers. To facilitate compliance with this requirement, the Letters provide no-action relief such that (1) for 30 months following the implementation date of MiFID II (*i.e.*, until July 3, 2020), broker-dealers may receive MiFID II-compliant research payments from investment managers that are directly subject to MiFID II or contractually obligated to comply with MiFID II (such as a U.S. sub-adviser of an EU investment firm) without becoming subject to regulation under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"); (2) the SEC would treat investment managers paying for research through a research payment account ("**RPA**") as falling within the safe harbor under Section 28(e) of the Securities Exchange Act of 1934, as amended ("**Section 28(e)**") when paying broker-dealers for research and brokerage services; and (3) investment managers that enter into research payment arrangements required by MiFID II may continue to aggregate orders for their advisory clients, including mutual funds, in reliance on previous no-action guidance. The Letters specify various conditions, as described below.

MiFID II will require the unbundling of execution and research payments.

MiFID II will, among other things, prohibit certain investment managers from receiving "inducements" from a third party in connection with providing any investment or ancillary service to a client, which can include an investment manager's receipt of research from an executing broker-dealer. However, pursuant to a related Delegated Directive under MiFID II, research provided to investment managers by third parties will not be regarded as an inducement prohibited under MiFID II if the research is received in return for: (i) direct payments out of the investment manager's own resources or (ii) payments from a separate RPA controlled by the investment manager and funded by a client by means of a research budget that will be set, regularly assessed and agreed upon with the client. Therefore, an investment manager subject to MiFID II may obtain research from third parties, including executing broker-dealers, either where it pays for the research directly from its own funds or where the research is paid for through a MiFID II-compliant RPA (or a combination of the two).

The MiFID II scheme for providing research services raises several issues for financial institutions that are subject to the U.S. federal securities laws. First, a broker-dealer's receipt of payments for research services, whether from an investment manager's own money or from an RPA, might subject such broker-dealer to the Advisers Act by calling into question its ability to rely on the broker-dealer exclusion from the Advisers Act. Second, investment managers that pay for research through the use of RPAs might not be entitled to rely on Section 28(e), which provides a conditional safe harbor from breach of fiduciary duty claims for investment managers that use client funds to purchase research services, because it is uncertain whether the RPA model satisfies the Section 28(e) requirement that payment of research "provided by" an executing broker-dealer be through "commissions." Third, because an investment manager may use different MiFID II-compliant research payment arrangements for different clients, the cost of an aggregated order might not be shared *pro rata* among all participating clients, as is required by SEC no-action letters that allow aggregation of certain client orders.

As discussed below, the SEC sought to provide greater certainty on these issues through the Letters.

Until July 3, 2020, broker-dealers may receive research payments pursuant to MiFID II without becoming subject to the Advisers Act.

Under Section 202(a)(11) of the Advisers Act, research services (*i.e.*, analyses or reports concerning securities), provided in exchange for compensation and as part of a regular business, generally constitute investment advice. Section 202(a)(11)(C) of the Advisers Act excludes from the definition of "investment adviser" any broker-dealer whose performance of such services is solely incidental to the conduct of its business as a broker or dealer *and who receives no special compensation therefor*. Because broker-dealers providing research services to investment managers subject to MiFID II will receive separate, specific payments in exchange for such research, they may be deemed to have received "special compensation" and, as a result, may become subject to the requirements of the Advisers Act, including agency cross and principal trading restrictions. The Securities Industry and Financial Markets Association ("**SIFMA**") submitted a no-action request seeking assurance that a broker-dealer that provides research services to investment managers in exchange for MiFID II-compliant payments would not become subject to the Advisers Act.

SIFMA argued that the history of legislative action and SEC guidance on broker-dealer research reflects a longstanding policy goal to preserve the accessibility of research services by providing flexibility for investment managers and broker-dealers to structure compensation arrangements for research services. According to SIFMA, subjecting broker-dealers to the Advisers Act when providing research services would run contrary to this goal and disrupt existing business models that are already subject to a comprehensive regulatory framework overseen by the SEC and the Financial Industry Regulatory Authority. Indeed, SIFMA argued that without the SEC's assurance that broker-dealers will not become subject to the Advisers Act by accepting MiFID II-compliant research payments, the implementation of MiFID II could disproportionately affect smaller market participants to the extent research coverage is reduced, and also could limit broker-dealers' ability to trade on an agency cross or principal basis with investment managers to which they provide research services.

Under the temporary no-action relief granted in the SEC's response (the "**SIFMA No-Action Letter**"), a broker-dealer may, without becoming subject to the Advisers Act, provide research services to an investment manager that is required, either directly or by contractual obligation, to pay for such research services with MiFID II-compliant research payments. The temporary relief will expire on July 3, 2020, 30 months from MiFID II's implementation date.

According to the SEC, during the period of the temporary relief, the SEC will monitor and assess the impact of MiFID II's research requirements on the research marketplace and affected market participants in order to determine whether more tailored or different action, including rulemaking, is necessary. The SEC has requested public comment on issues relating to the impact of MiFID II on broker-dealers, investors and the quantity and quality of research.

- **See a copy of the SIFMA No-Action Letter**

The SEC would treat investment managers as falling within the Section 28(e) safe harbor when paying broker-dealers for research and brokerage.

As noted above, investment managers subject to MiFID II will be able to make payments to broker-dealers for research services from a separate RPA controlled by the investment manager and funded by a client by means of a research budget that will be set, regularly assessed, and agreed upon with the client. The Asset Management Group of SIFMA ("**AMG**") submitted a no-action request seeking assurance that an investment manager that funds RPAs through collecting research payments from clients alongside execution payments may rely on the safe harbor provided by Section 28(e).

Section 28(e) generally protects an investment manager from liability for a breach of fiduciary duty solely on the basis of having paid more than the lowest commission rate to a broker-dealer for brokerage and research services, if the investment manager makes a good faith determination that the amount paid to the broker-dealer is reasonable in relation to the value of the brokerage and research services being provided. Among other things, Section 28(e) also requires that the research services be purchased using "commissions" and that the research services be "provided by" the broker-dealer involved in effecting the securities transaction.

AMG noted that investment managers in the U.S. currently often rely on the client commission arrangement ("**CCA**") model to pay for research using client transaction commissions. In a typical CCA, an investment manager places a client order through an executing broker-dealer and pays the broker-dealer a single commission for order execution as well as Section 28(e) eligible brokerage and research services. The executing broker-dealer credits the "research" portion of the commission to a CCA (either administered by the executing broker-dealer or by an external administrator) and retains the remaining "execution" portion of the commission. The investment manager then receives research services from the executing broker-dealer or a third-party research provider, which have been paid for by assets in the CCA.

According to AMG, the RPA model is expected to be identical to the CCA model in most respects, with two relevant distinctions: (1) in the RPA model, the amount paid for research is identified separately from the amount paid for execution *before* the investment manager makes the payment to the executing broker-dealer, while in the CCA model, the "research" and "execution" portions of the commission are separated *after* the investment manager makes a single, bundled payment to the executing broker-dealer; and (2) an RPA is required to be under the control of, and is the responsibility of, the investment manager. AMG further noted that when an RPA is operated in connection with a CCA, the research payments will continue to be paid to the executing broker-dealer, which will credit the payments to the CCA and pay such amounts into an RPA.

AMG argued that since the fundamental economic arrangement regarding the payment for research is the same in RPAs and CCAs, (i) a payment for research that is made alongside a payment for execution is equivalent to and should be considered a bundled "commission" for Section 28(e) purposes and (ii) where the executing broker-dealer is legally obligated to pay for research by transferring research payments made by an investment manager into an RPA, research provided by a third-party research provider should be considered as having been "provided by" the executing broker-dealer, as required by Section 28(e).[1]

Under the no-action relief granted in the SEC's response (the "**AMG No-Action Letter**"), the SEC would treat an investment manager as falling within the existing safe harbor provided by Section 28(e) if it pays for research services through the use of an RPA that conforms to MiFID II requirements, provided that all other applicable conditions of Section 28(e) are met. In particular, the SEC noted that the relief will apply only in the following circumstances:

- The investment manager makes research payments to the executing broker-dealer out of client assets alongside execution payments to the same broker-dealer;
- The research payments are for Section 28(e) eligible research services;
- The executing broker-dealer effects the securities transaction for Section 28(e) purposes; and
- The executing broker-dealer is legally obligated by contract with the investment manager to pay for research through the use of an RPA in connection with a CCA.

► **See a copy of the AMG No-Action Letter**

Investment managers may continue to aggregate orders for advisory clients, including mutual funds.

In a 1995 no-action letter issued to SMC Capital, Inc., the SEC stated that the mere aggregation of orders for advisory clients, including mutual funds and proprietary accounts, would not violate (i) Section 17(d) of the Investment Company Act of 1940, as amended (the "**Investment Company Act**") or Rule 17d-1 thereunder (which generally prohibit joint transactions between a registered fund and its first- or second-tier affiliates) or (ii) Section 206 of the Advisers Act (which generally prohibits an investment adviser from defrauding clients or prospective clients), if the investment manager implements procedures designed to prevent any account from being systematically

[1] In a CCA model, third-party research is deemed to be "provided by" an executing (or other effecting) broker-dealer if such broker-dealer "is legally obligated to pay for [the] research." *See* Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54165 (July 18, 2006).

disadvantaged by the aggregation of orders.[2] Among other things, the SEC's no-action position in *SMC Capital* was based on a representation that each participating client in an aggregated order would participate at the average share price with all transaction costs shared on a *pro rata* basis. The Investment Company Institute ("**ICI**") submitted a no-action request seeking an expansion of the *SMC Capital* position to cover the various research payment arrangements required by MiFID II.

As discussed above, an investment manager can comply with MiFID II by paying for third-party research services (1) directly from its own resources, (2) from a MiFID II-compliant RPA or (3) a combination of both. As such, an investment manager may potentially use different research payment arrangements for different clients (and/or pay for research out of its own resources for certain clients but not others), and the amount of the research payment made in respect of a particular transaction will depend on the client's applicable arrangement. As a result, although each client would continue to pay the same average share price and execution rates, *total* costs associated with a particular transaction may differ for each client depending on the client's research payment arrangement. Accordingly, each participating client in an aggregated order may not, as contemplated in *SMC Capital*, pay a *pro rata* share of all costs associated with the aggregated order.

The ICI argued that advisory clients would generally be benefited by permitting investment managers that enter into MiFID II-required research payment arrangements to continue aggregating client orders. In particular, the ICI noted that order aggregation may result in lower overall execution cost, prevent the investment manager from having to place competing orders in the same security, and lessen the potential of favoring one set of clients at the expense of another.

Under the no-action relief granted in the SEC's response (the "**ICI No-Action Letter**"), an investment manager that enters into research payment arrangements required by MiFID II can rely on the SEC's no-action position in *SMC Capital* with respect to the aggregation of client orders, provided that in addition to complying with the *SMC Capital* representations, the investment manager must adopt policies and procedures reasonably designed to ensure that:

- Each participating client in an aggregated order pays the average share price and the same execution cost (measured by rate);
- The research payment in connection with the aggregated order will be consistent with client disclosures as well as each applicable jurisdiction's regulatory requirements; and
- Subsequent allocation of such order will conform to the investment manager's allocation statement and/or allocation procedures.

► **See a copy of the ICI No-Action Letter**

[2] *See SMC Capital, Inc.*, SEC Staff Letter (pub. avail. Sept. 5, 1995).

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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