Chapman and Cutler LLP

Chapman Client Alert

October 31, 2017 Current Issues Relevant to Our Clients

SEC Staff Issues Trio of No-Action Letters to Address MiFID II Research Payment Issues for Broker-Dealers and Investment Advisers

The staff of the Securities and Exchange Commission ("SEC") issued three no-action letters designed to assist broker-dealers and investment advisers in addressing issues related to European Union ("EU") directives and related legislation that will become effective on January 3, 2018 ("MiFID II"). Investment managers often use client trading commissions to pay for both trade execution and research provided by executing broker-dealers. Among other things, MiFID II will effectively require EU investment managers to unbundle payments for research and trade execution so that they pay for research either by separate direct payment by the manager out of its own resources or from a separate "research payment account" ("RPA") funded by the advisory client. The no-action positions provide the following:

- **Investment Adviser Registration/Regulation**—temporary relief from registration and regulation under the Investment Advisers Act of 1940 ("Advisers Act") for broker-dealers that receive separate payments for providing research to EU investment managers in connection with trade execution;
- **Soft Dollar Safe Harbor**—relief allowing investment advisers to rely on the soft dollar safe harbor in Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act") even if they separately pay for research through RPAs; and
- **Joint Transactions**—relief from Investment Company Act of 1940 ("Investment Company Act") Section 17(d) and Rule 17d-1 and Advisers Act Section 206 for investment advisers that aggregate trade orders that accommodate differing research payment arrangements for different client accounts as required under MiFID II.

The SEC is also soliciting public comments on these topics and you may submit comments at the "webform" or "email" links in the SEC press release available here. The three no-action letters are available at these links: Investment Adviser Registration/Regulation, Soft Dollar Safe Harbor and Joint Transactions.

What Is MiFID II and Why Do U.S. Firms Care?

MiFID refers to the Markets in Financial Instruments Directive. The original MiFID has been applicable across the EU since November 2007 and is the foundation of the EU's regulation of financial markets. MiFID II revises the original MiFID package to take into account developments in the trading environment since the original implementation in 2007 and to make financial markets more efficient, resilient and transparent in light of the financial crisis.

While MiFID II generally does not apply directly to non-EU broker-dealers and investment advisers that do not have any EU place of business, many non-EU firms will likely encounter indirect impacts as a result of doing business with EU firms or their affiliates. Some non-EU firms may see an impact as a result of new requirements sought by EU firms, such as an executing broker-dealer being asked to receive separate payments for brokerage and research services rather than a single bundled commission. In other cases, EU firms may seek to contractually impose MiFID II or equivalent requirements on non-EU firms as a means of satisfying their own direct MiFID II requirements through delegation of obligations to the non-EU firm. The key indirect impact to U.S. broker-dealers, investment advisers and registered investment companies discussed in this Client Alert relates to MiFID II's requirements related to payments for research services by EU investment managers. These issues also impact EU investment managers that provide services to registered investment companies in the U.S. or that are registered in the U.S. under the Advisers Act.

MiFID II will generally prohibit certain EU investment managers from receiving certain "inducements" from a third party in connection with providing investment services. Among other things, "research" is a prohibited inducement unless an investment manager pays for the research (1) directly out of its own money, (2) from an RPA funded with a client's own money and with client approval, or (3) a combination of the two. The research payment also may not be linked to the volume or value of transactions executed on behalf of a client. As a result, MiFID II effectively requires that payments for research not be bundled into single payments for other services, such as trade execution. In the U.S., investment managers often use client commission arrangements to obtain brokerage and research services from a broker-dealer using a single, bundled commission that is separated after execution to pay for order execution and research. The MiFID II unbundling of research payments from commissions paid for trade execution creates several regulatory issues for U.S. broker-dealers, investment advisers and investment companies. The recent SEC no-action letters seek to address these issues.

Challenges for Broker-Dealers and SEC Relief

Advisers Act Registration/Regulation

As a result of MiFID II, EU investment managers that execute client trades through a U.S. broker-dealer will need to separate payments for trade execution from payments for research received from the broker-dealer. The issue that this creates for a broker-dealer is that a separate payment made in exchange for research provided by the broker-dealer could cause the broker-dealer to be deemed to be an “investment adviser” under the Advisers Act, requiring registration and regulation under the Advisers Act. The Advisers Act generally excludes broker-dealers from the “investment adviser” definition if the broker-dealer’s advisory services are solely incidental to the conduct of its business as a broker or dealer and the firm receives no special compensation for the services. Separate compensation for research could cause a broker-dealer to fall outside of this exclusion. Even dual-registered broker-dealers that are also registered as investment advisers under the Advisers Act could face difficulties if transactions were deemed to be covered by the Advisers Act due to the regulatory requirements and restrictions of the Advisers Act that would then apply to the transaction (such as the restrictions on agency and principal trading in Advisers Act Section 206(3)).

SEC Relief for Advisers Act Registration/Regulation

The SEC staff has provided temporary relief from registration and regulation under the Advisers Act to address these concerns. The SEC staff will 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 an EU investment manager that is required to pay for the research services by using research payments as required by MiFID II. This relief is only temporary at this point and will expire thirty months from MiFID II’s implementation date of January 3, 2018. During this period, the SEC staff will monitor and assess the impact of MiFID II’s requirements on the research marketplace and affected participants to ascertain whether more tailored or different action is necessary.

Challenges for Investment Advisers and SEC Relief

An investment adviser subject to MiFID II that provides services in the U.S. or to U.S. registered investment companies faces issues with respect to the safe harbor for soft dollar payments under Exchange Act Section 28(e) and with respect to joint transaction issues under Investment Company Act Section 17(d) and Rule 17d-1 and/or Advisers Act Section 206. Non-EU investment advisers can also face these issues as a result of contractual commitments or business arrangements with EU investment advisers, such as a non-EU manager acting as a sub-adviser to an EU manager.

Soft Dollar Safe Harbor

Exchange Act Section 28(e) provides a safe harbor for breaches of fiduciary duties on the basis that an investment manager uses client trading commissions to pay a broker-dealer more than the lowest available commission in exchange for brokerage services and eligible research (i.e., not pure execution services). Among other things, the safe harbor generally applies only to “commissions” and requires that the brokerage and research services be “provided by” the broker-dealer in exchange for the commission. MiFID II’s requirement of a research payment separate from the commission paid to a broker-dealer for trade execution creates a variety of issues for investment advisers seeking to rely on the Section 28(e) safe harbor even though the substantive economic arrangements might be similar.

Investment managers in the U.S. often use a client commission arrangement (“CCA”) to pay for research from third party research providers. Under a CCA, an executing broker receives a single bundled commission for trade execution and eligible research under the Section 28(e) safe harbor, including research provided by parties other than the executing broker. In cases where a third party provides research, the executing broker credits the portion of the commission for research to a CCA administered either by the executing broker or an external administrator. The investment manager then receives research from the third-party research provider who is paid by the CCA administrator (or executing broker administering the CCA). An RPA under MiFID II will work in a similar manner except (a) the research payment is separated from the commission paid for trade execution at the outset of a transaction and (b) the RPA is required to be under the control of the investment manager and the manager is held responsible for the RPA (but the manager can engage the broker or a third-party as administrator of the RPA in some cases). These issues raise questions as to whether an RPA structure is consistent with guidance under Section 28(e).

SEC Relief for Soft Dollar Safe Harbor

The SEC staff will not recommend enforcement action against a money manager seeking to operate in reliance on Exchange

Act Section 28(e) if it pays for research through the use of an RPA, provided that the manager meets all other applicable conditions of Section 28(e). This relief applies only in the following circumstances:

- The 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 payments are for research services that are eligible for the safe harbor under Section 28(e).
- The executing broker-dealer effects the securities transaction for purposes of Section 28(e).
- The executing broker-dealer is legally obligated by contract with the manager to pay for research through the use of an RPA in connection with a CCA.

Note that the current relief applies only to the use of RPAs and does not apply to direct separate payments by a manager for research as permitted under MiFID II.

Joint Transactions

Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder generally prohibit certain affiliated persons of a registered investment company, acting as principal, from participating in, or effecting any transaction in connection with, any joint enterprise or other joint arrangement in which the fund is a participant without SEC approval. Section 206 of the Advisers Act is the general antifraud provision of the Advisers Act and generally imposes a fiduciary duty on investment advisers. The SEC staff has issued guidance related to the application of these provisions to the aggregation of client account trade orders, including accounts of registered investment companies. In *SMC Capital, Inc.* (pub. avail. Sept. 5, 1995), the SEC staff stated that the mere aggregation of orders for advisory clients (including collective investment vehicles in which the adviser, its principals or employees have an interest) would not violate these provisions, subject to certain conditions. Among other things, the SEC staff position was based on a representation that each client who participates in an aggregated order will participate at the average share price *with all transaction costs* on a pro rata basis. The MiFID II requirement to separate execution and research payments means that clients participating in aggregated orders may not pay a pro rata share of *all* costs associated with that aggregated order (i.e., no or non-pro rata research payments) even though all clients would continue to pay the same average security price and execution costs.

SEC Relief for Joint Transactions

The SEC staff will not recommend enforcement action under Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder, or Section 206 of the Advisers Act, against an investment adviser that aggregates orders for the sale or purchase of securities on behalf of its clients in reliance on the position taken in *SMC Capital, Inc.* while accommodating the differing arrangements regarding the payment for research that will be required by MiFID II. The SEC staff position is based on each client in an aggregated order paying/receiving the same average price for the purchase or sale of the underlying security and paying the same amount for execution thereof. The staff position is also based on an adviser adopting 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.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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