ALERTS

Cross-Border Implementation of MiFID II Research Provisions — SEC No-Action Relief to Investment Advisers and Broker-Dealers and European Commission Guidance

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On Oct. 26, 2017, the U.S. Securities and Exchange Commission ("SEC") published three temporary no-action letters providing U.S. broker-dealers and investment advisers relief in the conduct of their business activities with entities subject to the European Union's Markets in Financial Instruments Directive ("MiFID II"), which will go into effect on Jan. 3, 2018. The no-action relief, described in further detail below, permits:

(1) **U.S. broker-dealers** to receive "hard dollar" payments from research payment accounts ("RPAs") from EU asset managers subject to MiFID II without having to register as an investment adviser under the Advisers Act;

(2) **Investment advisers** to continue to aggregate client orders while accommodating differing research payment arrangements that will be required under MiFID II, notwithstanding certain provisions and obligations of Section 17(d) of the Investment Company Act of 1940 and Rule 17d-1 thereunder and Section 206 of the Advisers Act; and

(3) **Investment advisers** to rely on the "soft dollar" safe harbor provided by Section 28(e) of the Exchange Act when the adviser makes payments for research to an executing broker out of client assets — alongside payments to the executing broker for execution — with the research

payments credited to an RPA administered either by the executing broker or a third-party administrator.

On the same day, the European Commission released its own FAQ to clarify how asset managers subject to MiFID II research provisions can purchase research services from U.S. and other non-EU broker-dealers.

Background

MiFID II will eliminate the ability of certain EU asset managers to pay for research services together with executions through a bundled commission payment and, instead, requires them to pay for research separately from execution services, either through direct payments from asset managers' own funds or from client accounts (through an RPA).

MiFID II also affects U.S. managers to the extent that they are:

- U.S. investment advisers with affiliated EU asset managers;
- U.S. investment advisers providing managed account or sub-advisory services to EU asset managers (e.g., through EU fund or managed account platforms) where the U.S. investment adviser is subject to contractual obligations to comply with MiFID II unbundling rules; or
- U.S. investment advisers without any EU presence or any EU managed account or sub-advisory arrangements that have entered into an agreement with an EU broker to purchase research in a manner that complies with the MiFID II unbundling obligations.

U.S. broker-dealers have been concerned that this provision of MiFID II would require them to register as investment advisers if they provided research to these asset managers on hard dollar payment terms, and U.S. investment advisers were unclear as to how their Exchange Act Section 28(e)-compliant research purchase practices would be affected to the extent that they obtained research in compliance with MiFID II unbundling requirements.

The SEC's no-action relief, which was designed in conjunction with European regulators and the European Commission, confirms that money managers and broker-dealers will continue to benefit from the protection provided by Exchange Act Section 28(e) and will not be in breach of U.S. federal securities laws when complying with MiFID II unbundling requirements. The no-action relief also ensures that EU asset managers

will not have their access to research from U.S. broker-dealers severely limited.

Division of Investment Management No-Action Relief

The first MiFID II no-action letter[1] allows U.S. broker-dealers, without having to register as an investment adviser, to provide research services to EU asset managers that are subject to MiFID II.[2] These EU asset managers will be required, under MiFID II, to pay for research services from:

- Their own funds;
- Separate RPAs funded by client assets; or
- A combination of the two

(collectively, "Research Payments").

U.S. broker-dealers that provide research services to EU asset managers expect to receive Research Payments for their research services and, absent the no-action relief, receipt of Research Payments might have subjected the U.S. broker-dealers to the substantive provisions of the Advisers Act as well as potentially the registration provisions of the Advisers Act. The no-action relief states that a U.S. broker-dealer providing such research services for cash consideration *will not be deemed to be an investment adviser* providing investment advice under Advisers Act Section 202(a)(11).

This no-action relief, which will expire thirty (30) months from Jan. 3, 2018, is intended to provide the SEC with sufficient time to better understand the evolution of business practices after the implementation of MiFID II. The SEC also notes that this no-action relief will allow the industry time to review, comprehend and implement the guidance and evaluate impacts on their business models. It will also allow the SEC time to monitor and assess the impact of MiFID II requirements on the research marketplace and affected participants in order to ascertain whether more tailored or different action is necessary, such as formal rulemaking.

The second MiFID II no-action letter[3] provides relief for SEC-regulated investment advisers that aggregate client orders while accommodating differing arrangements regarding the payment for research that will be

required under MiFID II. After MiFID II goes into effect, some clients within a given aggregated order may pay total transaction costs that include the cost of execution as well as research services, while other clients may pay different amounts in connection with the same order (i.e., for execution only) because of varying research arrangements or because the investment adviser elected to pay part or all of the research expenses for such clients with its own funds.

This no-action letter allows investment advisers to continue to aggregate client orders while accommodating differing research payment arrangements, provided that:

- The investment adviser implements procedures designed to prevent any account from being systematically disadvantaged by the aggregation of orders; and
- Each client in an aggregated order will continue to pay/receive the same average price for the purchase or sale of the underlying security and will pay the same amount for execution.

Division of Trading and Markets No-Action Relief

The third no-action letter[4] allows an investment adviser that pays for research through an RPA to continue to rely on the safe harbor provided by Exchange Act Section 28(e) when the investment adviser makes payments for research to an executing broker out of client assets — alongside payments to the executing broker for execution — with the research payments credited to an RPA administered either by the executing broker or a third-party administrator. This no-action relief, however, will only apply if the following four conditions are satisfied:

- The asset manager makes payments to the executing broker-dealer out of client assets for research alongside payments through an RPA to that executing broker-dealer for execution;
- The research payments are for research services that are eligible for the safe harbor under Exchange Act Section 28(e);
- The executing broker-dealer effects the securities transaction for purposes of Exchange Act Section 28(e); and

- The executing broker-dealer is legally obligated by a contract with the asset manager to pay for research through use of an RPA.

European Commission Views

In a coordinated action, the European Commission published FAQ guidance addressing two concerns surrounding the application of MiFID II to EU asset managers and non-EU managers contractually required to comply with MiFID II unbundling rules ("Third-Country Delegates") when they obtain research from third-country (i.e., U.S. and other non-EU) broker-dealers.

The European Commission issued the following welcome clarifications:

- EU managers and Third-Country Delegates may continue making combined payments for research and execution as a single commission to third-country broker-dealers, as long as the payment attributable to research can be identified separately. To this end, EU managers and Third-Country Delegates that operate an RPA for research payments must maintain a clear audit trail of payments to research providers and must be able to identify the amount spent on research with a particular third-country broker-dealer; and

- In the absence of a separate research invoice from a third-country broker-dealer, the EU manager or Third-Country Delegate should consult with the broker-dealer or other third parties with a view to determining the charge attributable to the research. In this case, the manager must also ensure that the supply of and charges for those benefits or services should not be influenced or conditioned by the levels of payment for execution services.

Implications

While the steps taken by the SEC no doubt temporarily reduce the burden on U.S. broker-dealers and asset managers of complying with MiFID II, preserve investor access to research, and accommodate the EU's changes without materially altering the U.S. regulatory approach, it remains to be seen whether this interim approach to addressing conflicting U.S. and EU requirements will be viable in the long run.

In addition, investment advisers subject to SEC regulations that will be directly or indirectly covered by MiFID II will have to finalize any needed

amendments to their expense review and allocation policies to confirm that they satisfy MiFID II as well as the new conditions and expectations set forth by the SEC and European Commission guidance.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Securities Industry and Financial Markets Association (Oct. 26, 2017) [SEC No-Action Letter].

[2] Section 202(a)(11)(C) of the Advisers Act generally excludes from the investment adviser definition any broker or dealer who performs investment advisory services (*i.e.,* who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities) and whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor.

[3] Investment Company Institute (Oct. 26, 2017) [SEC No-Action Letter].

[4] Asset Management Group of the Securities Industry and Financial Markets Association (Oct. 26, 2017) [SEC No-Action Letter].

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