The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 31125

March 12, 2018

Clarification Regarding SEC Relief on Aggregation of Trade Orders in the Context of MiFID II

[31125]

March 12, 2018 TO: ICI Members
ICI Global Members
Chief Compliance Officer Committee
Equity Markets Advisory Committee
ICI Global Regulated Funds Committee
ICI Global Trading & Markets Committee
International Operations Advisory Committee
SEC Rules Committee SUBJECTS: Compliance
International/Global
Investment Advisers
MiFID, EMIR, AIFMD, UCITS V RE: Clarification Regarding SEC Relief on Aggregation of Trade Orders in the Context of MiFID II

Background

The revised Markets in Financial Instruments Directive (MiFID II), which became effective on January 3, 2018, prohibits an investment adviser from receiving an "inducement" in connection with the provision of investment advice. MiFID II explicitly provides, however, that an investment adviser's receipt of research will not be regarded as a prohibited inducement if the research is received in return for: (1) direct payments out of the adviser's own resources; or (2) payments from a separate research payment account (RPA) controlled by the adviser and funded by means of a research budget that will be set, regularly assessed, and agreed upon with each client (*e.g.*, a registered fund).

To address concerns regarding whether global fund managers with affiliates subject to the new MiFID II framework requiring "unbundling" of research and execution could continue to aggregate orders for the sale or purchase of securities on behalf of their clients in reliance on the position taken in *SMC Capital, Inc.* (pub. avail. Sept. 5, 1995),[1]the Investment Company Institute (ICI) submitted a request for no-action relief to the Securities and Exchange Commission (SEC) staff.[2]

SEC Relief Regarding Aggregation of Client Orders

ICI requested assurances from the SEC staff that it would not recommend enforcement

action to the SEC under Section 17(d) of the Investment Company Act of 1940 and Rule 17d-1 thereunder, or Section 206 of the Investment Advisers Act of 1940 (Advisers Act), against an investment adviser that aggregates orders for the purchase or sale of securities on behalf of its clients (including registered funds) following the implementation of certain MiFID II requirements. Specifically, ICI requested that the staff expand the position taken in *SMC Capital, Inc.* with respect to the aggregation of orders to accommodate the differing arrangements regarding the payment for research that will be required by MiFID II.

On October 26, 2017, the SEC issued a no-action letter[3] stating that the SEC staff would not recommend enforcement action as requested 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 letter highlighted certain representations made in ICI's request. In particular, the staff noted that an adviser will 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.

Interpretation of Footnote 6 in the SEC Response Letter

At the end of the SEC's no-action letter, the staff included a footnote stating that "This position does not apply to an investment adviser that is not subject to MiFID II (either directly or contractually)." ICI and the fund industry immediately inquired about the meaning and purpose of the footnote. A strict reading of the footnote would appear to grant relief only to SEC-registered investment advisers that themselves are directly or contractually subject to these MiFID II provisions and would not provide relief to affiliated SEC-registered investment advisers that are not subject to MiFID II. The SEC staff has clarified and confirmed to ICI and members, including through remarks made at conferences,[4] that the relief granted is not limited to MiFID II obligated firms. Rather, the footnote is intended to communicate that, to rely on the relief provided in the letter, the research costs vary because of compliance with MiFID II requirements (*i.e.*, orders are being aggregated with an adviser that is subject to MiFID II).

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endnotes

[1] Representation 3 in *SMC Capital, Inc.* provides that "No advisory client will be favored over any other client; each client that participates in an aggregated order will participate at the average share price for all SMC's transactions in that security on a given business day, with transaction costs shared pro rata based on each client's participation in the transaction." *See* Response of the Office of Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated September 5, 1995, available at: https://www.sec.gov/divisions/investment/noaction/smccapital090595.htm.

[2] *See* Letter from Dorothy Donohue, Acting General Counsel, Investment Company Institute, to Douglas J. Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated October 20, 2017, available at: https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1-incoming.pdf.

[3] *See* Response of the Chief Counsel's Office, Division of Investment Management, U.S. Securities and Exchange Commission, dated October 26, 2017, available at: https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm.

[4] For example, this position was communicated at ICI's Securities Law Developments Conference held on December 7, 2017.
