The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 30929

October 26, 2017

SEC Issues No-Action Letters to Facilitate Cross-Border Implementation of MiFID II's Research Provisions; EU Commission Issues FAQs on Interaction with Third Country Broker-Dealers

[30929]

October 26, 2017 TO: ICI Members
Investment Company Directors
ICI Global Members
Equity Markets Advisory Committee
ICI Global Trading & Markets Committee
SEC Rules Committee SUBJECTS: International/Global
Trading and Markets RE: SEC Issues No-Action Letters to Facilitate Cross-Border Implementation of MiFID II's Research Provisions; EU Commission Issues FAQs on Interaction with Third Country Broker-Dealers

The SEC has issued three no-action letters to the ICI and other trade associations to allow market participants to comply with the research requirements of the revised Markets in Financial Instruments Directive (MiFID II) in a manner that is consistent with the US securities laws.[1] Subject to certain terms and conditions, the three no-action letters would permit: (1) investment advisers to continue to aggregate orders for mutual funds and other clients; (2) investment advisers to continue to rely on an existing safe harbor when paying broker-dealers for research and brokerage; and (3) broker-dealers, on a temporary basis, to receive research payments from money managers that are required under MiFID II, either directly or contractually, to pay for research in hard dollars or from advisory clients' research payment accounts.

The Commission of the European Union also issued two frequently asked questions and answers (FAQs) related to the application of MiFID II on third country broker-dealers' provision of research to MiFID-authorized asset managers and third country asset managers contractually obligated to comply with MiFID II.[2]

A brief background and a summary of the no-action letters and FAQs are provided below.

Background

Under MiFID II, an investment adviser's receipt of research would not be regarded as a prohibited inducement (*i.e.,* a monetary or non-monetary benefit in connection with the provision of investment advice) 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).[3]

Because MiFID II requires "unbundling" of research and execution costs, this new framework raises the question of whether global firms satisfying these new obligations would continue to be compliant with various US securities law provisions that are premised on bundled commissions. These potential conflicts could prevent global asset managers from continuing to run global trading desks and research programs in the manner that they currently operate.

ICI, along with other trade associations, therefore requested relief from the SEC under various provisions of the US securities laws to allow asset managers to continue to run their trading and research programs on a global basis.

Section 17(d) and Aggregation of Client Orders

ICI requested assurances from the SEC staff that it will 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.* (pub. avail. Sept. 5, 1995) with respect to the aggregation of orders to accommodate the differing arrangements regarding the payment for research that will be required by MiFID II.

As requested, the no-action letter stated 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*[4] 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.

Section 28(e) Safe harbor

The SEC staff also issued a letter stating that it will not recommend enforcement action to the SEC against a money manager seeking to operate in reliance on Section 28(e) of the Securities Exchange Act of 1934 if it pays for research through the use of an RPA in compliance with MiFID II, provided that all other applicable conditions of Section 28(e) are met.

In particular, the SEC staff noted that the relief will apply only in the following

circumstances:

- The money 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 money manager to pay for research through the use of an RPA in connection with a client commission arrangement.

Broker-Dealer Exclusion under the Investment Advisers Act

The Securities Industry and Financial Markets Association (SIFMA) requested assurance from the SEC staff that it will not take enforcement action under the Advisers Act against a broker-dealer that provides research services that constitute investment advice under section 202(a)(11) of the Advisers Act to an investment manager that is required under MiFID II, either directly or by contractual obligation, to pay for the research services from its own money, a separate RPA funded with its clients' money, or a combination of the two. Based on the facts and representations in the letter, the staff stated that it would not recommend enforcement action for a temporary period—the period would be 30 months from MiFID II's implementation date. The temporary period is intended to provide the staff with sufficient time to better understand the evolution of business practices after the implementation of MiFID II.

EU Commission's FAQs

The Commission issued two FAQs to address industry concerns related to the application of MiFID II on third country broker-dealers' provision of research and execution services to EU investment firms that provide portfolio management or other investment or ancillary services in the European Union (MiFID II Portfolio Managers) and third country sub-advisers that are contractually obligated to comply with MiFID II (Third Country Sub-Advisors).

In Question 1, the Commission clarified that a third country broker-dealer may receive combined payments for research and execution as a single commission when providing such services to a MiFID II Portfolio Manager or its Third Country Sub-Advisor as long as the payment attributable to research can be identified.

In Question 2, the Commission stated that where research is paid for through an RPA or directly out of the MiFID II Portfolio Manager's or its Third Country Sub-Advisor's own resources, the MiFID II Portfolio Manager/Third Country Sub-Advisor is responsible for identifying a separate charge for research supplied by third country broker-dealers.

Jennifer S. Choi
Associate General Counsel

endnotes

[1] *See* Investment Company Institute (pub. avail. Oct. 26, 2017), *available at* https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm; *see also* The Asset Management Group of the Securities Industry and Financial Markets Association (pub.

avail. Oct, 26. 2017), *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf; Securities Industry and Financial Markets Association (pub. avail. Oct. 26, 2017), *available at* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm.

[2]*See MiFID II: Interaction with Third Country Broker-Dealers*, *available at* https://ec.europa.eu/info/system/files/non-eu-brokers-dealers.pdf.

[3] To use an RPA: (1) the RPA must be funded by a specific research charge to the client (which must not be linked to the volume/value of transactions executed on behalf of the client); (2) the adviser must set and regularly assess a research budget which must be agreed upon with the client; (3) the adviser must regularly assess the quality of research purchased and its ability to contribute to better investment decisions; and (4) the adviser must provide to the client detailed information about the budgeted amount for research, the research costs actually incurred, the providers of research, the amount paid to such providers, and the benefits and services received from such providers.

[4] SMC Capital Inc., (pub. avail. Sept. 5, 1995), *available at* https://www.sec.gov/divisions/investment/noaction/smccapital090595.htm.
