November 2017

MiFID II: European Commission and U.S. SEC clarify position on "Soft Dollar" Arrangements for Asset Managers and Broker-Dealers

Introduction

Following various consultations with European authorities, including the European Commission, on 26 October 2017 the U.S. Securities and Exchange Commission (SEC) issued three related no-action letters that enable asset managers and broker-dealers to comply with the research provisions of the European Union's (EU) Markets in Financial Instruments Directive (2014/65/EU) (MiFID II)[1] in a manner that is consistent with U.S. federal securities laws and existing U.S. market practices

In particular, the SEC's no-action letters

(i) provide that broker-dealers may, for a temporary period of 30 months following MiFID II's 3 January 2018 implementation date, accept payments for research directly from asset managers or indirectly from an advisory clients' MiFID II-compliant research payment account (RPA)without being considered an investment adviser under the U.S. Investment Advisers Act of 1940 (Advisers Act);[2]

(ii) permit asset managers to continue to aggregate client orders for purchases and sales of securities under circumstances where all clients receive the same average security price and execution costs, notwithstanding that the clients may pay different amounts for research due to MiFID II requirements, without violating Section 17(d) of the U.S. Investment Company Act of 1940 (Investment Company Act), Rule 17d-1 thereunder, or Section 206 of the Advisers Act;[3] and

(iii) extend the safe harbor under Section 28(e) of the U.S. Securities Exchange Act of 1934 (Exchange Act) to permit an asset manager pay an executing broker-dealer for research out of client assets alongside payments for execution without breaching the manager's fiduciary duty, where the payment is made through the use of an RPA that complies with MiFID II requirements and provided other applicable conditions of the safe harbor are satisfied.[4]

Background –MiFID II and MiFIR

As most interested observers will be aware, the Markets in Financial Instruments Directive (2004/39/EC) (MiFID) will be repealed and replaced by MiFID II and the Markets in Financial Instruments Regulation (Regulation 600/2014) ("MiFIR").[5]

Member states of the EU must adopt and publish the measures transposing the Directive into national law and, with few exceptions, the provisions of both MiFID II and MiFIR will be in effect from **3 January 2018**.

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[1] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN
[2] https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm
[3] https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm
[4] https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf
[5] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN

"Soft Dollar" Arrangements – A Big Change for Asset Managers

"Soft Dollar" arrangements, the practice of paying brokerage firms for their additional services (such as research) through commission revenue, will be brought to an end under MiFID II. For many years, it has been common practice for asset managers to "bundle" trading and research costs together under a single, elevated commission fee on the understanding that the asset manager will use the broker-dealer in question to carry out trades in return for access to their specialised research.

However, under MiFID II, asset managers and broker-dealers will have to "unbundle" their research and trade execution costs and pay for them separately. The knock-on effects and considerations for asset managers and broker-dealers from January 2018 will be substantial. In the first instance, asset managers will need to decide whether to: (i) absorb the cost of paying for external research themselves or (ii) pass on the additional cost to their clients through the establishment of a separate RPA that satisfies various conditions required by MiFID II, including that the RPA includes a research budget agreed with the client, (ii) the manager owns, controls and is responsible for overseeing the RPA, and (iii) the manager regularly assesses the quality of the research purchased and its usefulness in making better investment decisions. On the other hand, broker-dealers serving asset managers will need to identify separate charges for research costs and commissions. The goal of the new regulation is to provide clients with greater transparency regarding costs attributable to research and those attributable to trade execution.

How are U.S. broker-dealers or sub-advisers affected?

- EU Announcement

The EU recently released a FAQ[6] in which it recognized the need to take into account different approaches to research payments outside the EU and ensure that EU asset managers, as well as their third country sub-advisers subject to MiFID II either directly or contractually, can continue to access research and execution services from third country broker-dealers, including U.S. broker-dealers. While the foregoing statement initially seems accommodating, its effects are not.

a) Single Commissions

The payment of a single commission to a third country broker-dealer in consideration for (i) research and (ii) execution services is permitted as long as the payment attributable to the research component can be identified. The MiFID II asset manager or its third country sub-adviser is responsible for maintaining a clear audit trail of payments made to research providers and being able to identify these payments to its own clients.

b) Identification of Research Charge

If a third country broker-dealer has not identified a separate charge for research supplied to the MiFID II asset manager or its third country sub-adviser, it may decide, among other things, to consult with third parties, including the third country broker dealer, with a view to determining the charge attributable to the research supplied. The supply of and charges for those benefits or services may not be influenced or conditioned by levels of payment for execution services.

- SEC No-Action Letters

In response to the position of the EU, the SEC issued the three related no-action letters referenced above, which are aimed at providing greater certainty to market participants seeking to comply with MiFID II requirements in a manner that is consistent with U.S. federal securities laws. The following summarizes the relief granted in each of the three no-action letters:

[6] https://ec.europa.eu/info/system/files/non-eu-brokers-dealers.pdf

a) Temporary Relief for Broker-Dealers

Under Section 202(a)(11) of the Advisers Act, an investment adviser includes any person who, for compensation and as part of a regular business, issues analyses or reports concerning securities. Broker-dealers that prepare analyses or reports on securities or other analogous research services for compensation are excepted from the definition of investment adviser so long as their provision of such services is "solely incidental" to the broker-dealer's business and no "special compensation" is received for such services.[7]

By requiring that asset managers "unbundle" their commissions to broker-dealers and separate out payments for research services, MiFID II created uncertainty as to whether a broker-dealer's receipt of separate payments for research could inadvertently subject it to the investment adviser registration requirements of the Advisers Act. Because the Advisers Act prohibits registered investment advisers from engaging in certain practices which are essential to a broker-dealer's traditional business, such as trading on both a principal and agency basis, the uncertainty created by the MiFID II research requirements could have led broker-dealers to discontinue their provision of research services so as to avoid becoming subject to registration under the Advisers Act.

In response to the concerns noted above, the SEC's Division of Investment Management issued a no-action letter that provided broker-dealers with temporary no-action relief from the registration requirements of the Advisers Act for a period of 30 months from MiFID II's implementation date where the broker-dealer provides research services to an asset manager that is required to comply with the MiFID II requirements and the manager pays for such research services with the manager's own money, from a separate, MiFID-governed RPA funded by the manager's client, or a combination of the two.

b) Relief for Aggregation of Orders

Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder are aimed at ensuring fair dealing and preventing overreaching in connection with joint transactions involving a registered investment company (RIC) and its affiliated persons, and generally prohibit an RIC from participating in joint transactions with affiliated persons on a basis different from or less advantageous than that of any other participant. Under Section 206 of the Advisers Act, investment advisers have an affirmative obligation to their clients to act in the utmost good faith and provide full and fair disclosure of all material facts. The fiduciary duty and general anti-fraud prohibition of Section 206 require an adviser aggregating client orders to do so in a manner consistent with its duty to seek best execution of those orders, and must ensure that the aggregation and allocation of orders is fair to all clients.

Following the implementation of MiFID II's research provisions, an asset manager's aggregated orders may include orders from (i) RICs and other clients not subject to MiFID II whose total transaction costs include both execution costs and research services, and (ii) other clients subject to MiFID II whose transaction costs for the order may differ from the costs incurred by the clients in (i), either because of different RPA budgetary arrangements or because the manager has agreed to use its own funds to purchase the research for such clients.

In effect, the varying research payments among the clients within the aggregated order could be viewed as inconsistent with the requirement that no client be systematically advantaged or disadvantaged by the aggregation. Accordingly, absent relief from the SEC, an asset manager that aggregates orders which include MiFID II-compliant "unbundled" execution orders could be found to violate Section 17(d) of the Investment Company Act, Rule 17d-1 thereunder and Section 206 of the Advisers Act on the grounds that all clients whose orders have been aggregated are not paying the same *pro rata* share of all transaction costs associated with the aggregated order.

[7] Advisers Act, sec. 202(a)(11)(C).

To ensure that asset managers can continue to aggregate and allocate orders that include MiFID II-compliant accounts in a fair and reasonable manner that does not systematically disadvantage any client, the SEC's Division of Investment Management has provided no-action relief under the Investment Company Act and the Advisers Act to permit asset managers subject to MiFID II (either directly or contractually) to continue to aggregate client orders for purchases and sales of securities, notwithstanding that some clients may pay different amounts for research because of MiFID II requirements, provided that the manager adopts policies and procedures reasonably designed to ensure that (i) each client in an aggregated order pays the same average price for the security and the same cost of execution, (ii) the research payment made in connection with the aggregated order is consistent with each applicable jurisdiction's regulatory requirements and disclosures to the client, and (iii) subsequent allocation of such trade will conform to the asset manager's established allocation statement and/or allocation policies and procedures.

c) Relief for Possible Breach of Fiduciary Duties

The fiduciary principles applicable to asset managers under the Advisers Act and U.S. state law require the manager to seek the best execution for client trades and generally preclude the manager from using client assets for the manager's benefit or the benefit of another client. With these fiduciary duties in mind, the use of client commissions to pay for research and brokerage services may give rise to potential conflicts of interest, as a manager may be incentivized to direct orders to a broker-dealer that does not offer clients the lowest trade commission rate in order for the manager to earn credits or other "soft dollar" benefits from the broker-dealer.

In recognition of the valuable role of broker-dealer research in managing client account, Section 28(e) of the Exchange Act provides a safe harbor for asset managers from liability for a breach of fiduciary duty if they use client commissions to purchase "brokerage and research services" for their managed accounts solely on the basis of having paid more than the lowest commission rate, if the manager determines in good faith that the amount of the commission is reasonable in relation to the value of such services. In practice, a U.S. asset manager often uses a client commission arrangement (CCA) to pay a single "bundled" commission that is separated by the U.S. broker-dealer *after* execution to pay for execution and research.

The no-action letter issued by the SEC's Division of Trading and Markets allows an asset manager to continue to operate within the safe harbor of Section 28(e) of the Exchange Act without breaching its fiduciary duty if (i) the asset manager makes payment for research to an executing broker-dealer out of client assets alongside payments for execution that conform to the MiFID II requirements, (ii) the research payments are for research services that are eligible for the safe harbor under Section 28(e), (iii) the executing broker-dealer effects the securities transaction for purposes of Section 28(e), and (iv) the executing broker-dealer is legally obligated by contract with the asset manager to pay for research through the use of an RPA in connection with a CCA.

d) Further SEC Evaluation

The SEC's temporary no-action relief described in (a) above is intended to facilitate compliance with the new MiFID II research provisions. The SEC staff has indicated that it will monitor and assess the impact of MiFID II in order to determine whether a more tailored or different action, including rule making, is necessary and appropriate.

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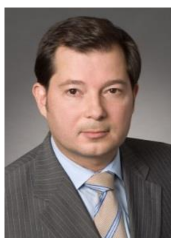

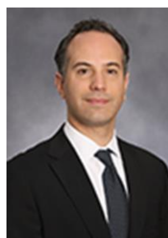

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