Analysis of the SEC's MiFID II No-Action Relief

Published by the Broker-Dealer & Investment Management Regulation Group
January 2018

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I. Introduction

On October 26, 2017, the Securities and Exchange Commission ("SEC" or the "Commission") staff issued three no-action letters to help broker-dealers, investment advisers and investment companies comply with the European directive known as MiFID II ("MiFID II" or the "Directive")[1] as it pertains to payment for research with minimum disruption to their business models in the United States.[2]

Under the no-action letters the SEC staff will not recommend enforcement action against the following:

- A broker-dealer that sells research to an investment manager subject to MiFID II without complying with the Investment Advisers Act of 1940 (the "Advisers Act");[3]
- A money manager that relies on Section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act") to pay for brokerage and research services while complying with the side-by-side payment mechanism under the Directive;[4]
- An adviser complying with MiFID II that relies on previous no-action relief from Section 17 and Rule 17d-1 of the Investment Company Act of 1940 (the "Investment Company Act") and Section 206 of the Advisers Act to aggregate orders for client accounts.[5]

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[1] Directive 2014/65/EU of the European Parliament and of the Council on Markets in Financial Instruments, 2014 O.J. L 173/349, and Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers, 2011 O.J. L 174/1.

[2] *See* Press Release: SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions (Oct. 26, 2017), available at https://www.sec.gov/news/press-release/2017-200-0 ("SEC Press Release").

[3] *See* Letter from Elizabeth G. Miller, Senior Counsel, Division of Investment Management, SEC, to Securities Industry and Financial Markets Association ("SIFMA"), dated Oct. 26, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm ("SIFMA Letter").

[4] *See* Letter from Heather Seidel, Acting Director, Division of Trading and Markets, SEC, to Asset Management Group ("AMG"), SIFMA, dated Oct. 26, 2017, *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf ("AMG Letter").

[5] *See* Letter from Aaron T. Gilbride, Senior Counsel, Division of Investment Management, SEC, to Investment Company Institute ("ICI"), dated Oct. 26, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm ("ICI Letter").

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All letters took effect on January 3, 2018. Relief under the SIFMA Letter was offered on a temporary basis, for 30 months ending July 3, 2020, to allow the SEC staff time to study the effects of MiFID II on the market for research and to determine whether another approach, including rulemaking, may be warranted. The Commission solicited public comment during this period to assist in its deliberation.

This client advisory discusses some of the more important issues raised by the letters.

II. Relief for Broker-Dealers from Compliance with the Advisers Act

The most significant relief concerns the temporary reprieve from compliance with the Advisers Act for broker-dealers that "unbundle" the cost of brokerage and research sold to investment managers under MiFID II.

An investment manager subject to MiFID II cannot accept research from a broker-dealer that executes its clients' trades unless the research is paid for out of the manager's own resources (hard dollars) or with client money (soft dollars) from a research payment account ("RPA") as prescribed by the Directive. Clients must consent to the use of their money to pay for research and a budget for research must be prepared for each client that agrees to pay for it. The RPA may be funded by billing clients for the money to be spent on research or by crediting the account an amount paid for research alongside a brokerage commission at an execution-only rate. The account may be administered by the broker-dealer executing the investment manager's trades or by a third-party administrator, but it must be under the manager's control. If the arrangement does not comply with MiFID II it may be considered an improper inducement of business.

Under Section 202(a)(11) of the Advisers Act, a broker-dealer paid for research is an "investment adviser" unless the research is "incidental brokerage" and not for "special compensation."[6] If it is an investment adviser, the broker-dealer must register with the SEC or the states in which it does business and comply with the Advisers Act.

The various means of paying for research required by MiFID II may be considered "special compensation" under longstanding authority on the broker-dealer exception in Section 202(a)(11)(C). The U.S. House of Representatives and Senate committee reports on the Advisers Act expressly state that commissions for brokerage transactions are the only form of payment acceptable under the exception.[7] An investment manager's hard dollar payment, divorced from brokerage, therefore, is not covered. The same is true for payments made through an RPA (including those alongside brokerage commissions at an execution-only rate) because the money must be used exclusively for research. Even if the side-by-side payment could be considered a commission, the identification of the charge to research could erode the exception under previous SEC interpretations maintaining that a commission scheme identifying a portion of the charge to investment advice is special compensation.[8]

The SEC Division of Investment Management said it would not recommend enforcement action under the Advisers Act if a broker-dealer provides research to an investment manager that is required by MiFID II, directly or by contract, to pay for it with its own money or with client funds from an RPA.

[6] Section 202(a)(11) of the Advisers Act defines the term "Investment Adviser" to mean:

> [A]ny person 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; but does not include . . . (C) any broker or dealer 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. . . .

15 U.S.C. § 80b-2(a)(11).

[7] *See* Senate Report No. 1775 (1940) 76th Cong., 3rd Sess. at 21; House Report Rep. No. 2639 (1940) 76th Cong., 3rd Sess. at 28. The SEC has interpreted this to include mark-ups and mark-downs on principal trades.

[8] The SEC's position was predicated on the notion that "a client who perceives that [he or she] is paying a charge specifically for investment advice is entitled to the protections of the Advisers Act." SEC Release No. IA-626, 43 Fed. Reg. 19224, 19226 (May 4, 1978). It can be said that the identified charge gives rise to consideration for the advice, changing the nature of the broker-dealer's relationship with its customer to that of an investment adviser notwithstanding that the nature of the advice is essentially unchanged.

The relief is narrow. It does not protect against all liability to clients under the Advisers Act; nor does it affect liability or enforcement under state blue sky laws that apply to investment advisers. Under the circumstances, broker-dealers that provide research to customers for an identified charge in response to MiFID II or otherwise should consider carefully the implications of the arrangements under the Advisers Act and state laws and, if necessary, register with the SEC or the states as an investment adviser and comply with requirements applicable to advisers as research providers under the arrangements.

Scope of the Relief

The no-action letter applies to all broker-dealers (registered and non-registered) to cover foreign broker-dealers providing research to MiFID II money managers as third-party producers under the exemption from registration in Rule 15a-6(a)(2) under the Exchange Act.[9] In most cases, a foreign broker-dealer can be expected to comply with substantial regulations governing the preparation and sale of research by a financial services firm in its home jurisdiction.[10]

The relief covers only the provision of research to European and other investment managers subject to MiFID II and to their sub-advisers that agree to comply with the Directive. It does not apply more broadly to similar arrangements in the U.S., whereby a broker-dealer is paid for research with hard dollars or soft dollars under a client commission arrangement ("CCA") that unbundles the cost from brokerage.[11] In those instances, the broker-dealer remains subject to compliance with the Advisers Act. In its request letter, SIFMA was optimistic that the relief would "inform how the SEC approaches similar circumstances involving payments for research services," and the staff "would respond favorably to no-action requests by broker-dealers . . . under similar circumstances." Formidable legal and political challenges, however, confront any relief that would curtail the Advisers Act as it applies to U.S. persons.

For more information, please click to see our video "Investment Advisers Act – Implications for Soft Dollar Arrangements, Part I."

Responsibility under the Advisers Act

The relief extends only to regulatory enforcement by the SEC staff. It does not protect a broker-dealer from potential liability to clients for failure to comply with the Advisers Act.

In *Financial Planning Association v. SEC*,[12] the U.S. Court of Appeals for the D.C. Circuit determined that the SEC lacked the authority to alter the exception for broker-dealers in the definition of investment adviser in Section 202(a)(11) of the Advisers Act. The federal court vacated Rule 202(a)(11)-1, which extended the exception to cover advice given by a broker-dealer in connection with a fee-based brokerage account (as distinguished from the traditional commission-based account).[13] In vacating the

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[9] Rule 15a-6(a)(2) does not permit a foreign broker-dealer to participate in a soft dollar arrangement with U.S. customers. The provision includes an express limitation that "[t]he foreign broker-dealer does not provide research to U.S. persons pursuant to any express or implied understanding that those U.S. persons will direct commission income to the foreign broker or dealer." Although not explicitly addressed in the relief, a U.S. money manager acting for the benefit of European clients under MiFID II might not be considered a "U.S. person" by reference to Rule 902 of Regulation S as it pertains to U.S. fiduciaries of non-U.S. clients.

[10] In 2007, the SEC's Division of Market Regulation (now the Division of Trading and Markets) issued no-action relief to Goldman, Sachs & Co. ("Goldman Sachs") to allow third-party service providers under its Research XPRESS program to be compensated for research out of commissions paid to Goldman Sachs without having to register as broker-dealers in accordance with Section 15(a) of the Exchange Act. *See* Letter from Brian A. Bussey, Assistant Chief Counsel, Division of Market Regulation, SEC, to Goldman, Sachs & Co., dated Jan. 30, 2007, *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2007/goldmansachs011707-15a.pdf ("Research XPRESS Letter").

The SIFMA Letter read in conjunction with the Research XPRESS Letter raises the question whether a U.S. entity can avoid regulation under the Advisers Act and the Exchange Act for research sold to clients subject to MiFID II. In the SIFMA Letter, the Division of Investment Management staff noted that the principal consideration for the relief was the potential for disruption to existing business models "that are already subject to an extensive regulatory framework overseen by the SEC and [FINRA]." Under the circumstances, we do not believe the relief allows a U.S. research producer to avoid regulation under both regimes.

[11] It is common under a CCA for a broker-dealer to credit to the investment manager a specified portion of the commission charged for brokerage to pay for proprietary or third-party research. The credit may result in special compensation for investment advice because it relates specifically to the cost of the research, similar to the side-by-side payments made through an RPA. *See supra* note 8 and accompanying text.

[12] 482 F.3d 481 (C.A.D.C., 2007).

[13] The rule was meant to accommodate the brokerage industry's expansion into fee-based accounts, typical of investment adviser relationships, which were thought to align more closely the compensation scheme with the quality of brokers' recommendations,

rule, the court said that "[b]y seeking to exempt broker-dealers beyond those who receive only brokerage commissions for investment advice, the SEC had promulgated a final rule that is in direct conflict with both the statutory text and the [House and Senate] Committee Reports." In this regard, the SEC staff's position in the SIFMA Letter similarly is at odds with the federal court's interpretation of the statute.

In general, there is only a limited private right of action under the Advisers Act. Section 215 provides that a contract made in violation of any provision of the statute is void.[14] A provision that would waive compliance is inoperable.[15] For a broker-dealer that does not comply with the Advisers Act, an agreement to provide research to an investment manager under MiFID II may be invalid (and the amount paid or owed under it subject to return or cancellation).[16]

Compliance with State Blue Sky Laws

The no-action letter does not affect civil liability or enforcement under the various state blue sky laws, which may impose registration, disclosure and other requirements similar to the Advisers Act.

Section 203A of the Advisers Act preempts state regulation of a federally registered investment adviser or a person that is excepted from the definition of investment adviser in Section 202(a)(11).[17] Section 222(d) of the Advisers Act generally precludes state regulation of an unregistered investment adviser if it had fewer than six clients in the state in the previous 12 months and does not have a place of business in the state.[18] The federal pre-emptions do not apply to the state's anti-fraud provisions. The SIFMA Letter may influence a state regulator's enforcement of investment adviser statutes against a

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without subjecting the accounts to the investment adviser regulatory regime. The shift coincided with an industry report highlighting the dramatic reduction in the cost of trade execution and noting the increased importance of recommendations and other advice as a component of the service provided to (and paid for by) clients. *See* Report of the Committee on Compensation Practices (April 10, 1995) ("Tully Report") at 3, 10, available at http://www.sec.gov/news/studies/bkrcomp.txt. The SEC changed its historic position to minimize the significance of the "special compensation" element of the exception where the advice given was part of the "traditional package of services" broker-dealers offered for commissions. SEC Release No. IA-2376, 70 Fed. Reg. 20424, 20431 (Apr. 19, 2005). In the latest relief, the SEC once again seems receptive to the idea that "MiFID II's unbundling requirements do not change the underlying nature of the relationship between broker-dealers and investment managers or the research services provided by broker-dealers," where previously it had found a change in the relationship in the compensation scheme.

[14] Section 215(b) of the Advisers Act provides:

> Every contract made in violation of any provision of this subchapter and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of any provision of this subchapter, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision.

15 U.S.C. § 80b-15(b)

[15] *See* Section 215(a) of the Advisers Act, 15 U.S.C. § 80b-15(a).

[16] A contract for the provision of research under MiFID II can be expected to include a representation or covenant by the provider, explicit or implicit, that it has all registrations and licenses necessary to perform under the agreement and will comply with applicable laws. Any representation or disclaimer designed to extend the effect of the no-action letter to limit liability to recipients of the research likely would be ineffective if the broker-dealer is, in fact, an investment adviser.

The same may be true with regard to the investment manager's right to pay for the research with client money to the extent the broker-dealer does not comply with the Advisers Act. Section 215(b) voids not only the broker-dealer's rights as an investment adviser under the contract but those of anyone else acquired under the agreement with knowledge of the broker-dealer's status. As a fiduciary to clients who are paying for the research or stand to benefit from it, the investment manager may be on inquiry notice of the broker-dealer's responsibility to comply with the Advisers Act and may not be privileged to waive the protections of the law (even apart from the operation of Section 215).

[17] In *Financial Planning Association*, the court found that the SEC lacked the authority under Section 202(a)(11)(F) of the Advisers Act to modify the broker-dealer exception. The decision left open whether the Commission could exempt a broker-dealer from registration and other requirements under its general rule-making authority in Section 211(a) of the Advisers Act. However, rulemaking under Section 211 would not preempt state regulation of the broker-dealer as an investment adviser.

[18] 15 U.S.C. § 80b-18a(d). Since the broker-dealer will provide the research from somewhere in the U.S., the federal *de minimis* exemption cannot be relied on to avoid registration and compliance in all states. It may, however, reduce the number of states in which compliance is required where research is provided to no more than five customers in the state. An argument may be made, by analogy to Regulation S, that an adviser in a state that pays for the research with money from non-U.S. clients on whose behalf it exercises investment discretion in accordance with MiFID II is not a U.S. person and, therefore, does not count for purposes of the federal *de minimis* standard.

broker-dealer affected by MiFID II's unbundling requirements. Otherwise, it has no effect on state investment adviser registration or other obligations.

State regulation of investment advisers is not uniform. Some states exclude a broker-dealer from the definition of investment adviser. Most states, however, adhere to the definition in the Uniform Securities Acts, which excepts a broker-dealer only to the extent that it provides investment advice incidental to brokerage and not for special compensation, similar to the Advisers Act. In those states, investment adviser status may be triggered by the unbundling of research by payments made with hard dollars, client money collected side-by-side with brokerage commissions or commission credits to a soft dollar account. Many states have some kind of an exemption from registration for an investment adviser whose clients are "institutional investors," although the definition of institutional investor may vary from state to state. Careful analysis is necessary to assess the application of state blue sky laws to broker-dealers acting as investment advisers.

In New York, where many broker-dealers have offices from which they provide research, the definition of "investment adviser" under the Martin Act is similar to the definition in the Advisers Act.[19] But in addition to the exception for broker-dealers it excludes "[a] person who sold, during the preceding twelve-month period, investment advisory services to fewer than six persons residing in the state, exclusive of financial institutions and institutional buyers."[20] The exception may be used to accommodate the sale of research to investment managers that comply with MiFID II if they are located outside New York. There is some ambiguity, however, as to the extent to which it covers the same sale of research to an investment manager residing in the state. The statute defines the term "institutional buyer" to include specified entities, "whether acting for itself or others in a fiduciary capacity," but goes on to identify "a federal covered investment adviser" to the extent it is "acting for its own account." [21] A narrow reading of the provision would appear to encompass the sale of research to an SEC-registered investment manager paying for research with hard dollars but not with client soft dollars.

Please click to see our client advisory on "MiFID II and Blue Sky Investment Adviser Registration."

Broker-dealers should beware that if the arrangement resembles payment for advice characteristic of an investment adviser relationship, a state may apply the heightened fiduciary standards attendant to the relationship in enforcing its anti-fraud provisions.[22] In this regard, the disclosures required to be made in an investment adviser's brochure delivered at the beginning of the relationship may help to limit liability by defining the nature and scope of the advisory relationship as it pertains to the provision of research.

Registration and Compliance with the Advisers Act

Given the limitations of the relief, a broker-dealer that unbundles research in response to MiFID II or otherwise should consider registering as an investment adviser.

Most firms prefer to register with the SEC over multiple state registrations. Registration with the SEC normally requires at least $100 million in assets under management. An advisory relationship based entirely on the provision of research ordinarily does not count toward meeting the threshold. Many broker-dealers are registered as investment advisers for their wealth management businesses. These firms need only update their registrations to account for their research activities. Other firms may be able

[19] Section 359-eee(1)(a) of the Martin Act defines the term "Investment Adviser" to mean:

> [A]ny person who, for compensation, engages in the business of advising members of the public, either directly or through publications or writings within or from the state of New York, as to the value of securities or as to the advisability of investing in, purchasing, or selling or holding securities, or who, for compensation and as a part of a regular business issues or promulgates analyses or reports concerning securities to members of the public within or from the state of New York. "Investment adviser" shall not include . . . [a] broker or dealer whose performance of these services is solely incidental to the conduct of his business as broker or dealer and who receives no special compensation for them. . . .

[20] Martin Act § 359-eee(1)(a)(5).

[21] N.Y. Comp. Codes R. & Regs., tit. 13 ch. II, subch. A, pt. 10, § 11.2(e). The definition also includes a "major U.S. institutional investor" as defined in Rule 15a-6, which includes a registered investment adviser with assets under management of more than $100 million, without other restrictions.

[22] *See e.g. UBS Financial Services, Inc.*, Smt. Agmt., SCNY, No. 06/405236 (July 10, 2007).

to rely on an exception from the assets under management test where they share offices with an affiliated adviser that is an SEC registrant. Also, there is an exception for foreign investment advisers and any adviser that would be required to register in 15 or more states.

Registration requires completion and filing of Form ADV. There are additional requirements including the preparation of a code of ethics, written compliance procedures, recordkeeping and other responsibilities. The broker-dealer regulatory framework should provide a foundation for meeting most requirements. The firm must prepare a "brochure" based on the information required by Part 2 of Form ADV, which must be delivered to clients at or before entering into an investment adviser relationship and at least annually thereafter if there are material changes to the document.

A broker-dealer that limits its advisory activities to research is relieved of some disclosure requirements applicable to advisers providing personalized advice.[23] Perhaps most important, Rule 206(3)-1 contains an exemption from the principal trade and agency cross restrictions under Section 206(3) of the Advisers Act for a registered broker-dealer that trades with customers in connection with research.[24] The rule was written specifically to accommodate broker-dealers that unbundle research for a separate fee or a defined charge.[25] Any obligations a broker-dealer has to recipients of research under the Advisers Act should not extend to other customers with whom it does not have an investment adviser relationship.[26] Similarly, the more comprehensive duties the firm might owe as an investment adviser to managed accounts should not apply to advisory clients for research services only.

For more information on the SEC investment adviser registration process for broker-dealers providing research services please click to see our video "Investment Advisers Act – Implications for Soft Dollar Arrangements, Part II."

III. Relief for Money Managers under Section 28(e) of the Exchange Act

In the AMG Letter, the industry sought assurance from the SEC Division of Trading and Markets staff that a money manager paying for research through an RPA funded by payments alongside commissions could continue to rely on the safe harbor from liability under Section 28(e) of the Exchange Act.

Under Section 28(e), an investment adviser or other fiduciary is protected from a claim of breach of fiduciary duty for causing a client to pay more than the lowest commission for brokerage and research services provided by a broker-dealer.[27] AMG asked for relief to ensure that the safe harbor would be

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[23] *See, e.g.,* Rule 204-3(c)(2), 17 C.F.R. §275.204-3(c)(2), excepting a registered investment adviser providing impersonal advice from the brochure supplement delivery requirement.

[24] Rule 206(3)-1, paragraph (a), provides in pertinent part:

> An investment adviser which is a broker or dealer registered pursuant to Section 15 of [the Exchange Act] shall be exempt from Section 206(3) in connection with any transaction in relation to which such broker or dealer is acting as an investment adviser solely: (1) by means of publicly distributed written materials or publicly made oral statements; (2) by means of written materials or oral statements which do not purport to meet the objectives or needs of specific individuals or accounts; (3) through the issuance of statistical information containing no expressions of opinion as to the investment merits of a particular security; or (4) any combination of the foregoing services: Provided, however, That such materials and oral statements include a statement that if the purchaser of the advisory communication uses the services of the adviser in connection with a sale or purchase of a security which is a subject of such communication, the adviser may act as principal for its own account or as agent for another person.

17 C.F.R. §275.206(3)-1(a). Under paragraph (b), any research or statement made in a public appearance must be delivered to 35 or more persons who pay for it.

[25] *See* SEC Release No. IA-626, 43 Fed. Reg. 19224 (May 4, 1978). In 1975, the SEC promulgated Rule 19b-3, which eliminated fixed commission rates. At the time, it was anticipated that competitive pressure would lead broker-dealers to offer premium and discount commissions—with and without recommendations or research—and perhaps the separate sale of research for a fee. The SEC said that the rule, "if followed by the 'unbundling' of brokerage commission charges and charges for research and other investment advice, could cause those [broker-dealers] who unbundle to become investment advisers as that term is defined in the [Advisers Act]." *Id.* at 19224. The Commission took steps to accommodate the transition by adopting Rule 206A-1(T), which temporarily exempted broker-dealers from registration as investment advisers to give them time to prepare for the new regime, and by creating a permanent exemption from the principal and agency cross-trading restrictions under Section 206(3) of the Advisers Act with the promulgation of Rule 206(3)-1. *See Id.* at 19225.

[26] *See* SEC Release No. IA-470, 40 Fed. Reg. 38158 (August 27, 1975) (adopting Rule 206(3)-1).

[27] Section 28(e) of the Securities Exchange Act of 1934 provides, in pertinent part:

available even if the research payments are not "commissions."[28] It also sought comfort that third-party research under the arrangement would be considered "provided by" the broker-dealer even though the RPA and all payments made through it must be under the control of the money manager. (The SEC previously has said that a broker-dealer must be legally obligated to pay for third-party research for it to be *provided by* the broker-dealer.)[29]

AMG posited that that the arrangement essentially is the same as a CCA, eligible for protection under the safe harbor, in which a portion of the commission is credited to an account that is used to pay for proprietary and third-party research. The SEC granted the request, saying it would not recommend enforcement action under Section 28(e) against a money manager that pays for research through the use of an RPA 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 CCA.

All other applicable conditions of Section 28(e) must be met.

The staff noted, as a reminder, that a broker-dealer may be liable for aiding and abetting a money manager's breach of fiduciary duty for failing to comply with Section 28(e).[30] Among other things, the broker-dealer should review the invoices and payments made by contract with the money manager to ensure that the RPA is used only to pay for "eligible" research in line with previous SEC guidance.[31] The broker-dealer should administer payments only with respect to third-party research that it has otherwise arranged to provide according to previous guidance to ensure that it is "in connection with a CCA."[32]

For more information on the SEC's guidance on CCAs under Section 28(e), please click to see our client advisory, "Client Commission (Soft Dollar) Arrangements: The Section 28(e) Safe Harbor."

IV. Relief to Allow Money Managers to Continue to Aggregate Clients' Orders

In a previous no-action letter to SMC Capital, Inc.,[33] the SEC staff granted enforcement relief from Section 17(d) and Rule 17d-1 of the Investment Company Act and Section 206 of the Advisers Act to

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> No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless . . . solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.

15 U.S.C § 78bb(e).

[28] Arguably, the research payment does not require protection under Section 28(e) because it must be approved in advance by the client. It is only the charge for brokerage at the execution-only rate, which is a commission, that needs the protection. Section 28(e) separately requires the adviser to evaluate the quality of the brokerage services to ensure that clients receive best execution. On that basis, all payments through an RPA should come within the scope of protection—not just side-by-side payments—so long as the broker-dealer provides some execution services to the money manager and the research is provided by the broker-dealer as otherwise required. However, the relief does not extend beyond RPA payments "alongside" payments for execution.

[29] *See* SEC Release No. 34- 54165, 71 Fed. Reg. 41978, 41994 (July 24, 2006)("2006 Soft Dollar Guidance").

[30] AMG Letter, *supra* note 4 at *3 n.6.

[31] *See* 2006 Soft Dollar Guidance, supra note 29.

[32] *See id.*

[33] *See* SMC Capital, Inc. (pub. avail. Sept. 5, 1995) ("The SMC Letter"), reaffirmed and clarified in Pretzel & Stouffer (pub. avail. Dec. 1, 1995), Mass. Mutual Life Ins. Co. (pub. avail. June 7, 2000).

allow an investment adviser to aggregate orders for clients' accounts (including certain accounts in which the adviser has an interest) provided, among other things, that all clients receive the average execution price and transaction costs are shared by them on a *pro rata* basis. In the ICI Letter, the staff of the Division of Investment Management extended the protection in the SMC Letter to advisers that comply with research payment arrangements under MiFID II that result in some clients paying different amounts (or nothing at all) for research.

The staff relied on ICI's representation that advisers would 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 (as described in the ICI Letter) and/or the adviser's allocation procedures.

In a footnote, the staff said that the position does not apply to an investment adviser that is not subject to MiFID II, which raises the question whether and on what conditions an adviser can combine an order for a client subject to MiFID II with one for a client not subject to the Directive. We expect clarification on this issue given the limited utility of the relief if combination cannot be made across both kinds of accounts.

The relief emphasizes the importance of the investment adviser's disclosures on "brokerage practices" under Item 12 of Form ADV Part 2A, including those regarding receipt of research and aggregation of orders for client accounts (which may be expanded to include the adviser's practices with regard to allocation).

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