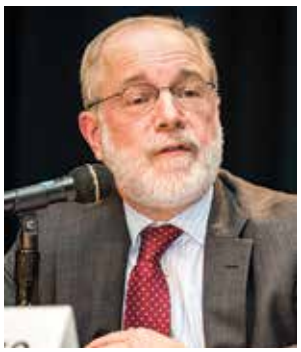
A MiFID II Reprieve

By Robert E. Plaze, Proskauer Rose LLP*

On October 26, the SEC staff issued three no-action letters that addressed implications on the U.S. securities industry of the implementation of European financial services regulations, collectively referred to as MiFID II, which take effect on January 3, 2018. This article discusses the import of those letters to U.S. asset managers and broker-dealers, but first provides some background on how it is that European Union ("EU") market regulations are having a significant impact on the ways U.S. financial service providers conduct their business.



Robert E. Plaze, a partner in the Washington, D.C. office of Proskauer Rose LLP, will be a featured speaker at the IAA's 2018 Compliance Conference next March.

How We Got Here

One of the original purposes of the formation of the EU was to create a single European market in which goods and services could flow freely among member countries the way interstate commerce does in the United States. A single market would allow European business to grow and achieve economies of scale necessary to compete with large U.S. firms, which had entered and in some cases dominated a damaged European market after World War II.

The European integration project eventually extended to financial services with the enactment of the EU Markets in Financial Instruments Directive or MiFID, which came into force across the EU in November 2007. For our purposes, one of the most important results was the creation of a legal framework supporting so-called UCITS funds that could be sold to retail investors across European borders. Today, approximately $11 trillion of investor assets are in UCITS funds. A similar framework was created for hedge funds and other alternative asset pools. These were extraordinary achievements; until 1996, a U.S mutual fund did not have the equivalent passport to sell in all of the U.S. states, some of which imposed their own regulatory requirements.

The UCITS passport regime has benefited U.S. advisers and their foreign affiliates, which are major players in the European UCITS market, both as sponsors of and sub-advisers to UCITS funds. And, of course, many UCITS funds invest in U.S. companies traded on U.S. stock exchanges in transactions executed by U.S. broker-dealers. Although U.S. mutual funds cannot be freely sold in the EU and vice-versa, the markets in which both types of funds invest are integrated. Hedge funds and other alternative investment vehicles are often offered globally.

The Use of Soft Dollars in Integrated Markets

One common feature of integrated financial markets has been the practice of bundling execution with research for a single price. Originally developed as a way for brokers to provide institutional customers a discount on fixed brokerage commissions (by offering free research), bundling continued long after fixed commissions were ended in the U.S. in 1976 and the U.K. in 1986. The practice of bundling was protected in the U.S. by Section 28(e) of the Securities Exchange Act of 1934 and permitted in the U.K. and other European markets on similar terms. As a result, transactions from European money managers could freely be sent to U.S. brokers and executed with trades from U.S. money managers and vice-versa. Trading and order management systems of global brokers and money managers have been built on this assumption.

U.S. and European regulation of bundling practices continued to converge, which further supported market integration. For example, the SEC drew on U.K. law and experience when, in 2006, it re-interpreted Section 28(e) to protect commission sharing arrangements ("CSAs"), which permit advisers to direct broker-dealers to pay for research with funds that the broker-dealer collects and pools from

Continued on page 9

trades it has executed.

Nonetheless, over the years, both the SEC and the U.K.'s Financial Services Authority (now reorganized as the Financial Conduct Authority) have at different times expressed concern that bundling execution with research presents conflicts of interest and that the lack of transparency of execution costs may hinder clients' ability to control them. In 1995, the SEC proposed, but never adopted, a rule that would have required SEC-registered advisers to provide clients with reports about their use of client brokerage and the research they received. Similarly, in 2001, the Financial Services Authority proposed, but also never adopted, a rebating scheme that would have effectively required advisers to unbundle execution.

MiFID II and Unbundling in the EU

Following the financial crisis in 2008, European political and regulatory authorities convened to consider changes in the structure and regulation of their financial markets to make them more resilient and to restore investor confidence. Out of that effort was born MiFID II, legislation that replaced MiFID and was intended to help modernize European markets and address certain unregulated and opaque aspects of the financial markets, such as derivatives, believed to have contributed to the financial crisis.

Similar to the 2010 Dodd-Frank Act in the United States, MiFID II addressed a number of matters that arguably had nothing to do with the financial crisis. One of these was the prohibition of the practice of bundling brokerage and research, which the British, having failed to accomplish in their home market, were able to persuade the EU to enact not long before deciding to leave.

MIFID II prohibits EU asset managers from receiving any form of research or other "inducements" from broker-dealers unless they pay for that research (i) out of their own resources or (ii) from research payment accounts ("RPAs") funded by each client, subject to an agreed-upon research budget that must be regularly re-assessed. The RPA may be funded from payments directly from a client as a separate research charge, or from payments made alongside brokerage transactions, in which case the amount of research charge cannot be tied to the value or volume of the client's transactions.

"Opponents of unbundling worry that the new EU rules will lead to reduced analyst coverage of smaller issuers and less efficient trading."

RPAs will work similar to the way CSAs operate now. A portion of each commission is held by the broker in an account used to fund research for money managers. The key difference is that pricing of execution and research must be kept separate, *i.e.,* they are fully unbundled. The EU regulators believe that separate pricing will lead to lower execution costs. Opponents of unbundling worry that the new EU rules will lead to reduced analyst coverage of smaller issuers and less efficient trading. Everyone agrees that the cross-border issues are now difficult.

Applicability to U.S. Advisers

EU regulators only assert jurisdiction over advisers domiciled in one or more of the EU member states.[1] As a result, most U.S. advisers without an EU place of business (even if they have EU clients) will be outside of the scope of MiFID II. They may, however, be affected in several ways. Some may delegate portfolio management to an EU sub-adviser, or may serve as a sub-adviser for an EU fund and be contractually obligated to comply with MiFID II. Perhaps more significantly, U.S. advisers may begin to be pressed by European and U.S. clients to pay research costs or to make available RPAs if they begin to produce the lower execution costs that EU regulators anticipate.

Some global advisers have already announced that they will begin paying for research from their own resources. This approach avoids the business and operational difficulties presented by RPAs, but may be a viable option only for advisers that are not reliant on broker-provided research or have deep pockets. Many advisers will be unable to take this approach, and all U.S. brokerage firms that execute trades from EU asset managers must be in a position to meet the new trading requirement of those customers. Therefore, industry groups sought and the SEC staff provided relief to address (or at least postpone) regulatory issues that have to date been identified for affected U.S. broker-dealers and advisers.

Advisers Act Relief for U.S. Broker-Dealers

The SEC staff letter issued responding to a request on behalf of the Securities Industry and Financial Markets Association ("SIFMA") addressed the question of whether U.S. and non-U.S. broker-dealers receiving MiFID II-compliant (*i.e.,* unbundled) payments for research would be subject to the Investment Advisers Act. This problem arises because (i) research would generally be considered investment advice and (ii) cash payments to brokers, either directly from the asset manager or indirectly from RPAs, would almost certainly be considered "special compensation" under long-standing interpretations of the Advisers Act, making unavailable the exception for broker-dealers in Section 202(a)(11)(C).

Issues that would arise if broker-dealers were to become subject to the

Continued on page 10

[1] In contrast, the federal securities laws claim jurisdiction over all domestic advisers *and* foreign advisers that have more than a *de minimis* number of clients and assets under management in the U.S.

Continued from page 9

Advisers Act appear to have been too difficult to resolve in time for MiFID II's effective date. Instead, the SEC staff stated that it will not recommend enforcement action under Section 202(a)(11) against a broker-dealer accepting hard dollar payments for research for 30 months from the date of the letter. The length of the period presumably reflects the time the SEC staff perceives necessary to figure out a solution, which may require rulemaking.

Perhaps the thorniest issue is the application of the Advisers Act's restrictions on principal trades, which could interfere with traditional broker-dealer activities. If delivery of research by a broker-dealer established a personalized client relationship, the trading that accompanied that relationship potentially would be subject to the Act. While some firms might be able to isolate or "ring fence" research activities in a separately registered division or subsidiary, research is often provided in connection with sales and marketing activities and trading personnel are frequently involved in creating the research.[2] As a result, and as argued by SIFMA, separating research and brokerage activities could be fraught with legal and operational issues.

The relief provided by the SEC staff was only partial, however, inasmuch as it is available *only* to a broker-dealer that receives hard dollar payments for research from a money manager (i) subject to MiFID II or (ii) that is contractually required to comply with MiFID II. Not addressed by the letter are U.S. advisers that might wish to voluntarily pay hard dollars for research, perhaps at the behest of an institutional client. This limitation was likely intentional and designed to limit the spread of unbundling. But the limitation would also appear to preclude brokers from aggregating trades from U.S. advisers (or other customers not subject to MiFID II) with those of their EU counterparts. This seems to be unintentional, and the SEC staff may be asked to revisit this condition, although it may be a challenge to do so without extending relief to all domestic advisers.

"Given the interconnectedness of global securities markets, neither the SEC nor the securities industry may be in a position to build a big wall, or to have the Europeans pay for it."

One question the SEC's postponement letter did *not* resolve was broker-dealers' obligations under state laws many of which contain exemptions for broker-dealers similar to the Advisers Act. The SEC is, of course, powerless to give assurances about state regulators or state law. The SEC staff's tact appears to have been to state that during the 30-month period it would "not consider" the broker-dealer as an "investment adviser" under the Act. This careful phrasing seems designed to invite state regulators, who frequently look to SEC interpretations, to take a similar approach (at least for the next 30 months) without the need to issue formal guidance.

Finally, it is still to be seen whether and how the SEC will be able to deal ultimately with the application of the Advisers Act to broker-dealers in this context. The SEC was faced with a similar problem in the early 2000s when broker-dealers began offering fee-based brokerage accounts. In 2005, the SEC adopted a rule under Section 202(a)(11)(F) of the Advisers Act, which gave it authority to deem a person not to be an adviser under the Advisers Act *and* state laws. Two years later, a federal appeals court struck down the rule, holding that the SEC could not expand the broker-dealer exemption, hamstringing the SEC's ability to redraw regulatory lines between broker-dealers and advisers in the face of converging business models.[3] Section 206A provides the SEC another source of exemptive authority, but does not trump state law and requires "best interest" findings the SEC staff may find difficult to make if relief is sought from the Act's anti-fraud provisions.

Trade Aggregation Relief for Advisers and Investment Companies

The SEC staff letter to the Investment Company Institute ("ICI") addressed the continued ability of an investment adviser to aggregate client trades in compliance with the Advisers Act and the Investment Company Act while complying with MiFID II.

The SEC has stated on many occasions that an adviser may aggregate client trades but must treat all the clients fairly by, for example, providing all clients average prices obtained during the trading day, allocating trading costs on a pro rata basis, and allocating partial fills of an order for a security pro rata among all accounts participating in the trade. While pro rata allocation is not the only permissible allocation approach, it is baked into some SEC staff letters, including its 1995 *SMC Capital, Inc.* no-action letter on which registered investment companies rely to aggregate their trades without obtaining SEC exemptive orders. Not surprisingly, that methodology also is reflected in many advisers' allocation policies.

Under the MiFID II regime, however, pro rata allocation of trading costs may not be feasible because payments for executing the same trade will vary among clients depending upon each client's arrangement with its adviser, the client's research budget and whether the adviser has decided to pay for research itself. The ICI argued that order aggregation benefits clients and that, without SEC assurance, advisers might be required to submit competing orders

Continued on page 11

[2] Other firms may be able to rely on Rule 206(3)-1, which, subject to certain conditions, exempts broker dealers providing impersonal advice (such as research reports) from the Adviser Act's restrictions on principal trades. Neither the requestor nor the SEC addressed the availability of Rule 206(3)-1.

[3] *Financial Planning Association v. SEC,* 482 F.3d (D.C. Cir. 2007).

for the same securities, which itself could benefit one group of clients over another. The SEC staff agreed.

In its letter to the ICI, the SEC staff stated that it would not recommend enforcement action if advisers subject to MiFID II aggregate client orders in reliance on the *SMC* letter. Advisers relying on the ICI letter must adopt policies and procedures reasonably designed to ensure that (i) each client in an aggregated order pays the average price for the security and the same cost of execution (measured by rate), (ii) 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 (iii) subsequent allocation of such trade will conform to the adviser's allocation procedures.

Trouble, however, was created by footnote 6 to the SEC staff letter, which limits the relief provided to an adviser subject to MiFID II directly or indirectly by contract. This limitation may swallow much of the relief granted if, as it appears, it would prevent an adviser from aggregating MIFID II-compliant trades with other trades because trading costs could not be allocated pro rata. A U.S. adviser contractually obligated to comply with MiFID II with respect to some trades would have to submit two competing orders for the same securities. Expect this footnote to be clarified sometime soon.

Safe Harbor for Soft Dollar Arrangements

The third in the trio of no-action letters was issued to SIFMA's Asset Management Group, but, unlike the other letters that were issued by the Division of Investment Management, was issued by the Division of Trading and Markets. It deals with the continued availability of Section 28(e) of the Securities Exchange Act for investment advisers subject to MiFID II.

Section 28(e) provides a safe harbor from liability for breach of fiduciary duty under both state and federal law when (i) an adviser causes a client to pay higher brokerage commissions in return for execution and research used to manage client assets, and (ii) when higher commission rates paid by some clients are used to subsidize research used to benefit other clients. The exemption protects market participants from liability under provisions of the Advisers Act, the Investment Company Act, ERISA, as well as state law. Consequently, the scope of the safe harbor has shaped market practices and customs, and many advisers voluntarily confine their use of soft dollars to that which is protected by Section 28(e).

Enacted in 1975, the SEC initially construed 28(e) narrowly as being available only for broker-dealer proprietary research, and later for third-party research as long as it was provided directly by the broker-dealer. In a 2006 interpretive release, the SEC broadened its construction of Section 28(e) and cleared the way for the development of CSAs, in which a portion of each client's commission is retained by the broker-dealer (or held by a third party aggregator) as a "soft-dollar credit" that accumulates and may be used by a money manager to pay for research. The question then turned on whether payments from a pool of client commissions to a research provider was the type of rebate on brokerage Congress did not intend Section 28(e) to protect because it benefited the money manager but not the client. The SEC, citing experience with similar CSAs in the U.K. and the benefits of increased transparency of execution costs, concluded that they did not raise such concerns.

The staff's letter to the SIFMA Asset Management Group extends the SEC's 2006 interpretive position to RPAs, subject to conditions similar to those for use of CSAs. However, by limiting the relief to payments made in connection with RPAs, the SEC letter is unclear whether broker-dealers relying on the letter may aggregate trades from EU asset managers subject to MiFID II with those from U.S. advisers. Perhaps the staff will provide additional clarity.

Conclusion

The SEC staff letters, while very helpful, should not be viewed as the end of the story. First, and most obviously, there is a 30-month clock that begins ticking down for broker-dealers. The inability of the SEC to figure out a way to re-draw regulatory lines that date back to 1940 could significantly affect the brokers' business models and sell-side research available to advisers. Secondly, there are certain to be legal and regulatory issues that no one has yet considered, including, for example, the applicability of the Advisers Act custody rule to RPAs structured under EU law. Third, the letters' incorporation of EU law in their conditions will mean that compliance officers of SEC-registered advisers relying on them are going to have to begin to pay attention to that law and its interpretation.

Finally, it will be interesting to see the extent to which MiFID II affects pricing of institutional brokerage in the United States. Ten years from now, will January 3, 2018 be remembered as another compliance and operational hurdle successfully overcome? Or will it instead be remembered as the equivalent of the "big bang" in 1975 when commission rates in the U.S. were unfixed, followed inevitably in Europe and other markets when trading in the U.S. became cheaper? Given the interconnectedness of global securities markets, neither the SEC nor the securities industry may be in a position to build a big wall, or to have the Europeans pay for it.

** Robert E. Plaze is a partner in the Washington D.C. office of Proskauer Rose LLP. Mr. Plaze may be reached at 202.416.6692 or rplaze@proskauer.com.* *This article is for general information purposes and is not intended to be and should not be taken as legal advice.*