

Broker-Dealer Beat: December 2017

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Unbundling research and execution costs for money managers subject to MiFID II means that US broker-dealers can expect to receive hard dollars or other separately identified payments for research, at least from EU managers. While the SEC has provided temporary no-action relief from investment adviser registration for firms accepting such payments from EU money managers, this will not relieve brokerage firms from applicable state investment adviser requirements.

MiFID II, a new series of European Union (EU) market regulations, becomes effective on January 3, 2018. Among other things, MiFID II bars an investment manager from receiving any inducements for conducting business, including research. Managers must either pay for research themselves in hard dollars or from a client funded account subject to several limitations, including the separate pricing of trade execution and research.

The receipt of separately identified payments for research, whether as a result of this unbundling or otherwise, means that a brokerage firm could be deemed to be receiving special compensation for investment advice, thus subjecting it to investment adviser registration. The SEC staff has issued limited no-action relief to address this concern. For the next 30 months, a broker-dealer providing research to EU money managers that constitutes investment advice will not be considered an investment adviser. But, the relief does not cover the receipt of separate payments for research from money managers who are not subject to MiFID. Nor does it resolve potential blue sky investment adviser registration issues.

The Investment Advisers Act prohibits states from applying their investment adviser registration laws to federally registered advisers. Even where an adviser is *not* federally registered, the Advisers Act prohibits a state from imposing its registration requirements on an adviser if it does not have a place of business within the state and has had fewer than six clients who are state residents during the last 12 months (the de minimus standard). But, broker-dealers who receive separate payments for providing research to six or more clients in a single state may be subject to that state's investment adviser registration requirements.

State registration may not be a concern for firms whose only clients paying separately for research reside in the EU. But some advisers subject to MiFID II, by contract for example, may be state residents. There are also US advisers who have decided to adhere to this MiFID protocol and pay for research separately from trade execution. If clients utilizing separate payment arrangements push a brokerage firm over the five client limit in any state, that state's investment adviser registration requirements will have to be considered.

Blue sky investment adviser registration requirements are not uniform. Even though a majority of states have adopted some version of the Uniform Securities Acts, many differences exist among the states' approaches to registration. Some states exempt a broker-dealer from the definition of investment adviser, but a much more common approach is to exempt only broker-dealers who receive no special compensation for advisory services. This is the issue the SEC provided relief on, and we believe that the staff intended for its relief to provide guidance to the states as well. Nonetheless, it is unclear the extent to which the states will follow the SEC staff's guidance.

Many states have some sort of exemption from investment adviser registration for firms whose clients are institutional investors. But the definition of institutional investor varies widely, thus necessitating a careful review of the law in any state where a brokerage firm anticipates exceeding the de minimus standard. There may be other available state law exclusions or exemptions, but these too would require state law analysis.

As practices evolve around unbundling research and execution costs, blue sky registration requirements may adapt to accommodate current market practices. But at least in the near term, firms should track the number of clients in each state to whom they are providing advisory services, including research for separately identified payments. Any brokerage firm not also federally registered as an investment adviser should carefully analyze a state's investment adviser registration requirements before exceeding the five client maximum.