Milbank

Financial Institutions Regulation Group

Client Alert

SEC Extends MiFID-Related Relief from Investment Adviser Registration

Extension Buys Time to Evaluate Broader Relief

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On November 4, 2019, the SEC Staff extended its prior no-action relief from investment adviser registration for broker-dealers that receive cash payments for their research.[1] The prior (and now extended) relief permits a broker-dealer to receive cash payments from certain types of investment managers without the broker-dealer having to register as an investment adviser. Without the no-action relief, a broker-dealer's mere receipt of cash for its research would be deemed "special compensation", as contemplated by Section 202(a)(11)(C) under the Investment Advisers Act of 1940, as amended (the "Adviser's Act"). The Adviser's Act excludes a broker-dealer from the definition of an investment adviser (and, as a consequence, does not require investment adviser registration) when it provides services that might otherwise constitute investment advice, so long as its provision of such services is "solely incidental to the conduct" of its broker-dealer business and the broker-dealer "receives no special compensation therefor."[2] Without the original no-action relief, a cash payment would be deemed "special compensation," thus preventing the broker-dealer from otherwise relying upon the "solely incidental" exclusion and requiring the broker-dealer's registration as an investment adviser. Investment adviser registration would have additional consequences, such as subjecting a broker-dealer/investment adviser to the disclosure and consent provisions for principal and agency cross transactions of Section 206(3) of the Adviser's Act and the rules promulgated thereunder.

Relief Limited to Payments from Managers Subject to MIFID II

The no-action relief, however, applies only to the receipt of cash payments from certain types of investment managers, namely managers directly or by contractual obligation subject to MiFID II, the updated version of the European Union's Markets in Financial Instruments Directive regulating the financial markets and its participants. Among other things, MiFID II requires "unbundling" of research

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[1] See Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (Nov. 26, 2019) (the "2019 No-Action Extension") extending the relief provided in Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (Oct. 26, 2017) (the "2017 No-Action Relief").

[2] Advisers Act, Section 202(a)(11). The SEC recently provided guidance on the "solely incidental" exclusion, particularly with respect to investment discretion and account monitoring services. See Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser, Release No. IA-5249 (June 5, 2019).

payments from brokerage expense by requiring an investment manager subject to MiFID II to pay for the research with its own money, from a Research Payment Account (as that term is defined in MiFID II regulations) funded by client money and with client approval, or from a combination of the two. MiFID II therefore sets up a cross-border regulatory conflict. The EU framework encourages an investment manager to pay cash for the broker-dealer's research. The US regulatory framework, however, discourages such payment, as the payment would subject the broker-dealer to investment adviser registration. Strangely, in this context, the Adviser's Act registration requirement turns not on any substantive requirement or services provided, but rather solely on the form of payment. If the payment is made in cash -- the very form MiFID II encourages -- the exemption is not available. But if the payment is made though a "soft dollar" or a "client commission arrangement" pursuant to the safe harbor under Section 28(e) of the Exchange Act of 1934, as amended, the Adviser's Act exemption is available, and no registration is required.[3] The 2017 no-action relief was designed to reconcile this cross-border inconsistency in time for MiFID II's implementation in January 2018.

Continued Cross-Border Inconsistency

The no-action relief (both the original relief and its extension) resolved one cross-border regulatory inconsistency but reinforced another. The relief allows EU managers to unbundle and pay directly for research from US broker-dealers but does not allow the same treatment for US managers. As a result, a global investment manager cannot administer its research payments universally. That is, it can pay directly for its research received by affiliated managers subject to MiFID II but cannot pay directly for research received by affiliated US managers that are not subject to MiFID.[4] Again, the difference in regulatory result does not turn on any substantive difference in services – in both cases the US broker-dealer is providing research to an investment manager. All that differs is the jurisdiction in which the investment manager is registered and operates.

So why does the 2017 No-Action Relief and the 2019 No-Action Extension provide different treatment based on jurisdiction? One could potentially draw a distinction based on regulatory requirement: a US manager not subject to MiFID II voluntarily elects to unbundle and make a cash payment while the EU manager subject to MiFID II must pay for its research with hard dollars based upon regulatory

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[3] The 2019 No-Action Extension confirmed that investment adviser registration is not required in this circumstance. See 2019 No-Action Extension at n.8 and footnote 4 below.

[4] For more than a decade, the SEC has "recognize[d] the benefit to investors of money managers being able to functionally separate trade execution from access to valuable research" and has allowed unbundling through commission sharing arrangements between broker-dealers. See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Release No. 34-54165 at 57 (July 18, 2006)("2006 Release"). In the 2019 No-Action Extension, the SEC staff has confirmed that payment pursuant to such arrangements does not constitute "special compensation" and therefore does not require investment adviser registration. See 2019 No-Action Extension at n.8 ("Therefore, the staff believes that the use of these [commission sharing arrangements] does not affect whether the broker-dealer exclusion [from the definition of investment adviser] may be available in connection with the receipt of payments for research under section 28(e)").

This results in an additional form-over-substance distinction. Although a US manager cannot pay the broker-dealer directly for research, it can unbundle the cost of the research through a commission sharing arrangement. Such unbundling determines the cost of the research. See 2006 Release at 49 ("Finally, where a broker-dealer also offers its research for an unbundled price, that price should inform the money manager as to its market value . . . ."). Once the price of the research is determined, the manager can then make a cash payment to the account that indirectly paid for the research. Such reimbursement, however, adds unnecessary administrative complexity. Where the economic result is the same (the manager has paid cash for the research it receives from a broker-dealer), the process should not be unnecessarily cumbersome and the SEC should permit direct payments from investment managers subject to and not subject to MiFID II.

requirements as influenced by market practice.[5] This distinction is without a difference for a number of reasons. First, it fails to recognize that global markets and market participants are inter-related. That is, in an inter-related global market, market practice and conduct in one jurisdiction often migrates to another.[6] Said differently, MiFID II might have brought about direct payment for research in the EU by regulation, but also might have brought about such practices in the US through market practice.[7] If the effect of MiFID II is sufficient justification for permitting cash payments by an EU manager, is the consequential effect of MiFID II on US managers any less sufficient justification? Second, the "regulatory obligation" distinction overlooks that voluntary payments and regulatorily-encouraged payments are driven by the same policy objective: transparency of costs. MiFID II's unbundling and payment practices reflect a belief that separating research from execution costs and paying for them separately from the manager's own funds allows a manager to assess better (and separately) the value of the research and the cost and quality of executions it receives. Should a different result obtain when a market participant voluntarily acts on this belief rather than having the belief imposed upon it? If cost transparency is a sufficiently sound policy to allow cash payments from managers subject to MiFID II, is it any less sound when those same payments come from investment managers not subject to MiFID II?

Next Steps

The SEC staff is aware of and appreciates the disparate treatment US managers currently receive under the 2017 No-Action Relief and the 2019 No-Action Extension. In extending the 2017 No-Action relief well in advance of its July 3, 2020 expiration, the SEC staff has provided certainty that investment managers subject to MiFID II can continue to pay US broker-dealers for research after July 3, 2020. With this additional "breathing room", the SEC staff can continue to evaluate the effects of MiFID II among research providers and upon research budgets in the EU, in the United Kingdom upon its exit from EU, and in the US. There is strong hope that the SEC staff will abandon the form-over-substance distinction, continue to embrace unbundling of research expense from and execution costs, and allow investment managers in any jurisdiction to pay for a broker-dealer's research without causing the broker-dealer to have to register as an investment adviser and be subject to regulatory requirements applicable to investment advisers and their affiliates.

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[5] While MiFID II allows payments from a research payment account, investment managers subject to MiFID II generally seek to pay for research from its own funds.

[6] The 2006 Release recognized "the globalization of the world's financial markets" and that market participants operate across borders. See 2006 Release at 20.

[7] The publication of the 2006 Release itself acknowledges the inter-connectedness of the securities markets, regulatory requirements, and market practices. The release was published following the adoption of a rules in the United Kingdom relating to the use of client commissions, including the practice of unbundling research and execution costs. 2006 Release at 19-20. In particular, the 2006 Release acknowledged "the United Kingdom's regulatory efforts in this area [that] allow money managers to use client commissions to pay separately for trade execution by the broker-dealer that can provide the best execution and ask the executing broker to allocate a portion of the commission directly to an independent research provider or allocate a portion of the commission to a pool of 'credits' maintained by the broker-dealer and from which the broker-dealer . . . may pay independent research providers. . . ." 2006 Release at 52.

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