CLIENT ALERT

No-Action Relief to Facilitate Cross-Border Implementation of MiFID II for Broker-Dealers Expiring in July

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SEC staff no-action relief that allows broker-dealers to receive cash payments for research without being deemed investment advisers subject to registration under the Investment Advisers Act of 1940 (Advisers Act) is scheduled to expire on July 3, 2023. The SEC staff originally issued this no-action relief in 2017, which it described as "temporary" for registered broker-dealers and foreign broker-dealers operating under Rule 15a-6 under the Securities Exchange Act of 1934 (Exchange Act) (the "SIFMA Letter").[1] The SIFMA Letter was extended in 2019.[2] In July 2022, William Birdthistle, the director of the SEC's Division of Investment Management, announced in a speech that the SEC staff would allow the relief to sunset.[3]

The SIFMA Letter allows broker-dealers to receive direct payments (i.e., "hard dollars") for research services from investment managers subject to MiFID II and sub-advisers of MiFID II advisers, who are contractually bound to comply with MiFID II, from their own accounts, a separate account funded with clients' money or a combination of the two, without causing the broker-dealer to be regulated as an investment adviser under the Advisers Act. The SIFMA Letter is one of

1 *See* Securities Industry and Financial Markets Association, Division of Investment Management SEC Staff No-Action Letter (Oct. 26, 2017), https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm.

2 In November 2019, the SEC staff issued another no-action letter to SIFMA extending the temporary assurances to July 3, 2023. Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (Nov. 4, 2019) (the "SIFMA Extension Letter"), https://www.sec.gov/investment/sifma-110419.

3 *See* William Birdthistle, *Remarks at PLI: Investment Management 2022*, (July 26, 2022), https://www.sec.gov/news/speech/birdthistle-remarks-pli-investment-management-2022-072622.

three letters granted on October 26, 2017 providing relief to investment advisers, registered investment companies and broker-dealers to grant "greater certainty regarding their U.S.-regulated activities as they engage in efforts to comply" with the European Union's (EU) Markets in Financial Instruments Directive (MiFID II).[4] The other two letters are not expiring. In response to the scheduled expiration of the relief, SIFMA has issued a statement urging the SEC to extend the relief in the SIFMA Letter (the "2023 SIFMA Statement").[5]

Background

Fiduciary principles in the United States and the EU require money managers to seek "best execution" for client trades and restrict the ability of money managers to use client assets for their own benefit.[6] Recognizing the value of research to clients, the U.S. Congress enacted Section 28(e) of the Exchange Act to provide a safe harbor to protect money managers from liability for a breach of fiduciary duty solely on the basis that they paid more than a lower commission rate in order to receive "brokerage and research services" provided by a broker-dealer, if the conditions of the safe harbor are met. Section 28(e) preempts other fiduciary and related laws addressing conflicts of interest between money managers and their clients, including the fiduciary provisions of the Employee Retirement Income Securities Act of 1974 (ERISA), the provisions of Section 17 of the Investment Company Act of 1940 (Investment Company Act) and the anti-fraud provisions of Section 206 of the Advisers Act. The Section 28(e) safe harbor has facilitated the provision of research by broker-dealers through commissions rather than direct payments (commonly referred to as "soft dollars"), and has allowed broker-dealers that provide research, which is deemed to be investment advice, to rely on an exclusion in the Advisers Act from the definition of "investment adviser."[7]

The EU, in adopting MiFID II, took a substantially different approach in addressing the same fiduciary and conflict-of-interest concerns that prompted the enactment of Section 28(e). MiFID II prohibits investment managers from receiving or retaining "inducements" in connection with the conduct of their business. "Inducements" include a wide range of monetary and nonmonetary benefits, including research. Payments for research are not considered to be unlawful inducements if the investment manager pays for the research separately from execution costs and (i) directly out of its own resources, or (ii) with client approval, through a MiFID II-compliant research payment account ("RPA") funded by client money based on a

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

5 *See* Securities Industry and Financial Markets Association, The SEC Should Take Immediate Action to Preserve Critical Research Under MiFID II, (Feb. 21, 2023) at https://www.sifma.org/resources/news/the-sec-should-take-immediate-action-to-preserve-critical-research-under-mifid-ii/.

6 *See, e.g.*, Commission Guidance Regarding Client Commission Practice Under Section 28(e) of the Securities Exchange Act of 1934, SEC Rel. No. 34-54165 (July 18, 2006).

7 Section 202(a)(11)(C) of the Advisers Act excludes from the definition of "investment adviser" "any broker or dealer whose performance of such [investment advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." The exclusion has been interpreted to treat client commission payments for research services as not being "special compensation" and to treat investment advice provided through the research as being "solely incidental" to how the broker–dealer conducts its brokerage business. Hard dollar payments for research, on the other hand, have been interpreted by the SEC to be "special compensation" for purposes of this exclusion.

research budget or (iii) a combination of the two.[8] The MiFID II requirements created a dilemma for U.S. broker-dealers providing research, because receipt by them of a direct, hard dollar, payment could subject them to regulation in the United States as an investment adviser.

In light of the conflicts between the two regimes and the difficulty of complying with both, U.S. broker-dealers and investment advisers, among others, sought relief from the SEC staff. As noted in the SEC's press release, the no-action relief was designed to "take a measured approach" to allow firms to comply with MiFID II "while respecting the existing U.S. regulatory structure."[9]

Division of Investment Management No-Action Relief – SIFMA Letter

The SIFMA Letter provides "temporary" relief to allow registered broker-dealers and foreign unregistered broker-dealers operating pursuant to Rule 15a-6 under the Exchange Act to accept direct, "hard dollar" payments for research services that constitute investment advice under the Advisers Act without becoming subject to the definition of "investment adviser" under the Advisers Act. Under this relief, the hard dollar payments may only be from EU/UK investment managers directly subject to MiFID II and non-EU advisers who are contractually required by an EU/UK investment manager to comply with MiFID II, for example, under a sub-advisory agreement. Under the SIFMA Letter, payments to the broker-dealer may be made (i) by the investment adviser from its own funds, (ii) from an RPA funded with money from the adviser's clients, or (iii) a combination of the two.

SIFMA Requests Extension of No-Action Relief

The SIFMA Letter originally provided the relief for 30 months from MiFID II's implementation date, and the SEC staff subsequently extended the relief so that it expires on July 3, 2023.[10] The 2023 SIFMA Statement urges extension of the current no-action relief beyond July 3 because the SIFMA Letter has been key to helping to preserve a market for investment research by providing relief from the conflicts between U.S. and international laws impacting research providers and investment managers since the implementation of MiFID II. SIFMA highlights that the introduction of MiFID II led to the reduction of research consumed by managers subject to its requirements and that, in light of the reduction in the amount of research available in the EU, EU regulators have proposed rolling back the MiFID II requirement to pay for research through unbundled payments and have proposed instead to allow research to be paid for through bundled commission payments. The 2023 SIFMA Statement argues that the expiration of the no-action relief in July 2023 will lead to a further reduction in

8 *See* Commission Delegated Directive Supplementing the MiFID II Directive, Art. 13.1 (Apr. 7, 2016) at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L0593&rid=1.

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

10 *See* SIFMA Extension Letter, *supra* note 3, at https://www.sec.gov/investment/sifma-110419.

available research and argues that the SEC should extend the no-action relief to allow time for foreign regulatory changes related to the unbundling requirement to "work through the regulatory process."

The 2023 SIFMA Statement also notes that, because the original 2017 no-action letter was issued "to provide the staff with sufficient time to better understand the evolution of business practices after the implementation of MiFID II," an extension is "critical to avoid significant, irreversible and entirely unnecessary disruptions to the market for investment research" and that it is counterproductive for U.S. institutions to change operations to comply with foreign regulatory requirements that appear likely to change substantially, if not to be rescinded altogether.[11]

Conclusion

The SIFMA Letter is scheduled to expire July 3, 2023, at which time the current relief provided to broker-dealers will no longer be available. After this date, broker-dealers will no longer be able to rely on the SIFMA Letter to receive direct payments for research services from investment managers subject to MiFID II and sub-advisers of MiFID II advisers, who are contractually bound to comply with MiFID II, without considering the broker-dealer's status as an investment adviser under the Advisers Act. This is expected to impact smaller broker-dealers and specialty research providers particularly hard because investment advisory firms often elect to use their limited commission dollars to pay for general research from larger broker-dealer firms.

[11] Note that the UK/EU proposals are separate but in each case may only apply to research in relation to some companies, not all (such as the large, listed companies).

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