1401 H Street, NW, Washington, DC 20005-2148, USA
202-326-5800 www.ici.org

October 20, 2017

Douglas J. Scheidt, Esquire
Associate Director and Chief Counsel
Division of Investment Management
US Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-8549

Re: Request for No-Action Relief for Advisers to Aggregate Client Orders

Dear Mr. Scheidt:

The Investment Company Institute[1] seeks assurances from the staff of the Division of Investment Management ("Staff") that it will not recommend enforcement action to the Securities and Exchange Commission ("Commission") under Section 17(d) of the Investment Company Act of 1940 ("Investment Company Act") and Rule 17d-1 thereunder, or Section 206 of the Investment Advisers Act of 1940 ("Advisers Act"), against an investment adviser that aggregates orders for the purchase or sale of securities on behalf of its clients (which may include registered investment companies ("RICs")), as described below, following the implementation of certain MiFID II (defined below) requirements. Specifically, ICI requests that the Staff expand the position taken in *SMC Capital*, *Inc*. (pub. avail. Sept. 5, 1995) ("*SMC*") with respect to the aggregation of orders to accommodate the differing arrangements regarding the payment for research that will be required by MiFID II. The aggregation of orders has benefitted clients (including RICs) for over 20 years since the issuance of *SMC*. Absent the expansion of the relief granted in *SMC*, advisers may be forced to place into the market competing orders in the same security, resulting in worse execution for clients overall and the potential to benefit one set of clients at the expense of another, precisely the harm that the relief granted to *SMC* sought to prevent.

[1] The Investment Company Institute ("ICI") is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and unit investment trusts ("UITs") in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$20.5 trillion in the United States, serving more than 100 million US shareholders, and US$6.7 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

I. BACKGROUND

The Markets in Financial Instruments Directive ("MiFID"), which has been in force since 2007, is the framework of European Union legislation for investment intermediaries that provide services to clients with respect to financial instruments and the organized trading of financial instruments.[2] In 2014, the European Parliament and the European Council adopted an updated version of MiFID, referred to as MiFID II, which introduced significant changes to the restrictions on inducements received or paid by an investment firm (*i.e.*, an adviser).[3] On April 7, 2016, the European Commission published a Delegated Directive ("Delegated Directive") setting out the final provisions regarding inducements and, specifically, the use of dealing commissions for investment research.[4] The MiFID II regulatory reforms will go into effect in the European Union on January 3, 2018.[5]

The Delegated Directive requires the separation of execution and research payments. Specifically, Chapter IV, Article 13(1) of the Delegated Directive provides that research provided to advisers by third parties will not be regarded as an inducement (*i.e.,* a monetary or non-monetary benefit in connection with the provision of investment advice) prohibited under MiFID II[6] if the research is received in return for: (1) direct payments out of the adviser's own resources;[7] or (2) payments from a separate research payment account ("RPA") controlled by the adviser and funded by means of a research budget that will be set, regularly assessed, and agreed upon with each client.[8] Therefore, an adviser

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[2] *See* Directive 2004/39/EC of the European Parliament and of the Council of April 21, 2004 on Markets in Financial Instruments, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32004L0039.

[3] MiFID II comprises both a European Union directive (the Markets in Financial Instruments Directive) as well as a separate European Union Regulation (the Markets in Financial Instruments Regulation).

[4] *See* Delegated Directive Supplementing the MiFID II Directive (April 7, 2016), *available at* https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2031-EN-F1-1.PDF.

[5] Member States of the EU were required to adopt national legislation implementing MiFID II by July 3, 2017.

[6] Delegated Directive, *supra* note 4, at Article 11. The Delegated Directive assumes that such inducements would create conflicts of interest between an adviser and its clients.

[7] *Id*. at Article 13(1)(a).

[8] *Id*. at Article 13(1)(b). Where an adviser uses an RPA, the Delegated Directive requires that: (1) the RPA must be funded by a specific research charge to the client (which must not be linked to the volume/value of transactions executed on behalf of clients); (2) the adviser must set and regularly assess a research budget which must be agreed upon with clients; (3) the adviser must regularly assess the quality of research purchased and its ability to contribute to better investment decisions; and (4) the adviser must provide to its clients detailed information about the budgeted amount for research, the research costs actually incurred, the providers of research, the amount paid to such providers and the benefits and services received from such providers. *Id.*

may obtain research from third parties, including executing brokers, either where it pays for the research directly from its own funds or where the research is paid for from a MiFID II-compliant RPA. Advisers subject to MiFID II may utilize either permissible approach with respect to their affected clients (or a combination of both). For example, an adviser may elect to implement an RPA where feasible but may also elect, for various reasons, to pay for research from its own resources for other clients (*e.g.,* where a client is unable or unwilling to pay a separate research charge).

Under MiFID II, research payments may continue to be collected alongside brokerage commissions to fund an RPA, provided that the amounts charged to clients in connection with the trade include both a distinct execution component and a distinct research component; and the distinct research component (*i.e.,* a research charge) is determined based upon the client's individually agreed upon research budget.[9] RPA arrangements structured in this manner will be substantively similar to client commission arrangements and commission sharing arrangements (collectively, "CSAs") commonly used today, with certain administrative and operational differences. In a CSA, an adviser directs trades to a broker-dealer and pays a "bundled" commission comprised of both an execution charge and a research charge. The adviser is then generally able to direct the research portion of the commissions to the executing broker-dealer for proprietary research or to other third-party research providers.

In an RPA subject to MiFID II, an adviser will direct a trade to a broker-dealer and transmit the research payment alongside the execution payment. The broker-dealer will then retain the execution payment and remit the research payment, collected alongside the execution payment, to the RPA. The adviser is then able to distribute the funds in the RPA to pay for investment research products and services. Unlike the CSA, however, the amount of the payment attributable to research may vary by client depending upon the client's applicable arrangement in relation to the payment for research. The amount of the research charge collected in respect of a particular transaction through an RPA depends on the applicable research budget. In addition (or alternatively), an adviser may elect to pay for research from its own resources for other clients where an RPA is not feasible. Therefore, even though execution rates remain constant, total costs associated with a particular transaction may vary depending upon the client's applicable arrangement.

II. LEGAL ANALYSIS

Section 17(d) of the Investment Company Act provides that the Commission may adopt rules that limit or prevent RICs from participating in joint transactions with affiliated persons on a basis different from, or less advantageous than, that of any other participant. Rule 17d-1(a), adopted thereunder, generally prohibits a first- or second-tier affiliated

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[9] *See id*. at Article 13(3). Research payments also may be deducted from client accounts at the time of each trade.

person of a registered fund, acting as principal, from participating in, or effecting any transaction in connection with, any joint enterprise or other joint arrangement or profit-sharing plan in which the RIC is a participant, unless an order approving the transaction has been issued by the Commission.[10] The phrase "joint enterprise or other joint arrangement or profit-sharing plan" is defined as:

> any written or oral plan, contract, authorization or arrangement, or any practice or understanding concerning an enterprise or undertaking whereby a registered investment company . . . and any affiliated person of . . . such registered investment company, or any affiliated person of such a person . . . have a joint or a joint and several participation, or share in the profits of such enterprise or undertaking.[11]

Section 17(d) and Rule 17d-1 are designed to prevent overreaching in connection with joint transactions involving a RIC and its affiliated persons.[12] The Commission, its Staff, and the courts have emphasized that some element of combination or profit motive (in contrast to contemporaneous but independent actions) must be present for Section 17(d) and Rule 17(d)-1 to apply.[13]

Section 206 of the Advisers Act makes it unlawful for an investment adviser, directly or indirectly, "(1) to employ any device, scheme, or artifice to defraud any client or prospective client" or "(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Section 206

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[10] Section 2(a)(3) of the Investment Company Act defines an affiliated person of another person to include, among other things, any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of the other person, any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the other person, or any investment adviser of an investment company.

[11] Rule 17d-1(c) under the Investment Company Act.

[12] *See Hearings on S. 3580 Before Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3rd Sess. 256 (Apr. 9, 1940) (statement of David Schenker, Chief Counsel, Securities and Exchange Commission, Investment Trust Study) (indicating that the purpose of Commission rules to be promulgated under Section 17(d) (originally drafted as Section 17(a)(4)) is to "insure fair dealing and no overreaching").

[13] *See SEC v. Talley Industries Inc.*, 399 F.2d 396, 403 (2d Cir. 1968), cert. denied, 393 U.S. 1015 (1969) (stating that while Section 17(d) is not limited to the typical joint venture, "some element of 'combination' is required"); *Steadman Security Corp.*, 1974-75 Fed. Sec. L. Rep. (CCH) ¶80,038 at 84,848 (Dec. 20, 1974) (stating Rule 17d-1 "is concerned with joint enterprises or joint arrangements that are in the nature of a joint venture, *i.e.*, that involve the element of seeking to realize a profit or gain through the investment of funds"); *Bloom v. Bradford*, 480 F. Supp. 139, 145 (E.D.N.Y 1979) (Section 17(d) "requires an intentional act of agreement or at least a consensual pattern . . ."); *SMC* (stating that "some element of combination or profit motive must generally be present for [S]ection 17(d) and [R]ule 17d-1 to apply").

generally imposes a fiduciary duty on an investment adviser to act in the utmost good faith with respect to its clients and to provide full and fair disclosure of all material facts.[14]

1. Previous Staff Positions

The Staff has issued a number of no-action letters relating to the application of Section 17(d) and Rule 17d-1 to aggregated orders.[15] In 1995, *SMC* sought the Staff's concurrence that aggregating orders among RICs and other clients, under certain circumstances, would not violate Section 17(d), Rule 17d-1, or Section 206. The Staff stated that "the mere aggregation of orders," including for RIC accounts, would not violate Section 17(d) (or Rule 17d-1) so long as the RICs participated on terms "no less advantageous than other participants." To meet that standard, *SMC* represented that, among other things: (1) once the aggregated order was executed, the trade would be allocated among clients in accordance with a pre-trade written statement specifying the participating client accounts and the intended allocation among them ("Allocation Statement"), and, in the event the order was only partially filled, allocated *pro rata* based on the Allocation Statement; (2) each client that participated in an aggregated order would participate at the average share price; and (3) transaction costs would be shared *pro rata* based on each client's participation in the transaction. The Staff also granted no-action relief under Section 206 of the Advisers Act in connection with these activities.[16]

The Staff reaffirmed and clarified this position in a subsequent letter stating that "the mere aggregation of orders for advisory clients, including collective investment vehicles in which the adviser, its principals, or employees have an interest, would not violate Section 17(d) of the Investment Company Act or Section 206 of the Advisers Act if the adviser implements procedures designed to prevent any account from being systematically disadvantaged by the aggregation of orders." *Pretzel & Stouffer* (pub. avail. Dec. 1, 1995) ("*Pretzel & Stouffer*"). With respect to Section 206 of the Advisers Act, the Staff stated that "[a]n adviser that aggregates client orders must do so in a manner consistent with its duty to seek best execution of the orders, and must ensure that all clients are treated fairly in the aggregation and allocation."[17] The Staff further noted that

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[14] *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 184 (1963).

[15] *SMC*; *Pretzel & Stouffer* (pub. avail. Dec. 1, 1995); *Massachusetts Mutual Life Insurance Co.* (pub. avail. June 7, 2000).

[16] This request is not intended to supersede the relief granted in *SMC*; the relief granted in this request would provide an alternative approach regarding Section 17(d), Rule 17d-1 and Section 206 in the context of order aggregation.

[17] *Pretzel & Stouffer*.

"an adviser must disclose to its clients its policies with respect to the aggregation of orders."[18]

The Staff also issued a no-action letter regarding the application of Section 17(d) to the aggregation of certain purchases and sales of privately placed securities. *Massachusetts Mutual Life Insurance Co*. (pub. avail. June 7, 2000) ("*MassMutual*"). Explaining that concerted activity may involve potential conflicts of interest, the Staff in *MassMutual* noted that affiliates must have "both a material pecuniary incentive and the ability to cause the investment company to participate in the transaction" to trigger Section 17(d) concerns.[19] The Staff acknowledged that, unlike private placements, "aggregated orders for the purchase or sale of publicly traded securities in the secondary market are unlikely to create . . . a conflict of interest" situation where an adviser is incentivized to cause an investment company client to participate in an aggregated purchase that is not in its best interest.[20]

2. Challenges Posed by MiFID II and the Need to Expand *SMC*

The *SMC* letter includes a representation that transaction costs be shared by clients *pro rata* based on each client's participation in the transaction. As explained above, advisers that are subject to MiFID II will be required to enter into new arrangements with clients regarding payment for research, with each client having a separate budget for research (or no budget at all) depending on individual arrangements.[21] Affiliates of these firms may simultaneously advise (or sub-advise) clients located in the US (or other jurisdictions outside the EU) that may pay for research through bundled commissions or CSAs. After MiFID II goes into effect, within a given aggregated order, for example, (1) clients (including RICs) may pay total transaction costs that include the cost of execution as well as research services; whereas (2) other clients may pay different amounts in connection with the same trade (including possibly execution only) because of varying research arrangements and budgets and/or if the adviser has elected to pay for research for such clients in whole or part using its own resources. As a result of the various potential research arrangements and combinations thereof, such clients may not pay a *pro*

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[18] *Id.*

[19] The term "material pecuniary interest" is not defined in *MassMutual*. Instead, the Staff gave examples of material pecuniary interests such as instances in which the adviser causes a fund to participate in a transaction with an account in which employees of the adviser have a material financial interest, or when the adviser uses the size of the fund's order of securities as a means to gain a larger allocation of the offering for itself.

[20] *Id.*

[21] MiFID II obligations apply to MiFID-authorized investment firms regardless of the location of their clients. Therefore, a MiFID-authorized firm that is an adviser to US-domiciled funds and accounts would be required to comply with the MiFID II obligations on dealing commissions and research payments with respect to those clients.

rata share of *all* costs (*i.e.*, research payments) associated with that aggregated order as contemplated in *SMC* although all clients will continue to pay the same average security price and execution rates.

The Staff's letters state that no-action relief for aggregating orders is predicated on the representation that RICs do not participate on terms that are less advantageous than other participants in the trade. Post-MiFID II, each client in an aggregated order will continue to pay/receive the same average price for the purchase or sale of the underlying security and will pay the same amount for execution thereof. We do not believe that different arrangements or the payment of varying amounts for research should preclude an adviser's ability to aggregate orders on behalf of its clients. So long as (1) each client pays (or receives) the average price for the security and pays the same execution rate, (2) the research payments are made consistent with applicable regulatory requirements and disclosures to the client, and (3) the trades are allocated as determined by the Allocation Statement and/or the adviser's allocation procedures, no client will be systematically disadvantaged. The adviser will have no rational incentive to cause the RIC (or any other client) to participate in the order other than to improve execution for all participants.[22]

In general, an investment adviser has a fiduciary obligation to treat its clients fairly and equitably in the provision of advisory services.[23] However, this obligation does not translate into each client paying the same amount for and receiving the same benefit from the research: the Commission has acknowledged that "Section 28(e) allows an [adviser] in making a good faith determination as to the reasonableness of the commissions paid to consider not only the benefit to be derived by the account paying the commission but the benefit derived by other accounts."[24] ICI believes that aggregating orders, under the circumstances described herein, will minimize the risk that any particular account will be systematically advantaged (or disadvantaged).

To ensure that orders continue to be aggregated and allocated in a fair and reasonable manner that will not systematically disadvantage any client, advisers will adopt

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[22] To the extent that all participants pay (or receive) the same average share price in a given aggregated order, any differential in the total transaction costs for certain clients would result from varying research payments. The safe harbor in Section 28(e) of the Securities Exchange Act of 1934 contemplates that commissions may include the cost of research so long as such payments are reasonable in relation to the value of the (brokerage and) research provided.

[23] *See Pretzel & Stouffer*.

[24] *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934*, Exch. Act Rel. No. 23170 (Apr. 23, 1986). The Commission also has clarified that Section 28(e) protects an adviser that benefits from the acquisition of research purchased with client commissions from liability for violating Section 17(e) of the Investment Company Act. *See id.; see also Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Exch. Act Rel. No. 54165 (July 18, 2006).

policies and procedures 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 execution 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,[25] and (3) the subsequent allocation of such trade will conform to the Allocation Statement and/or the adviser's allocation procedures. Additionally, if the adviser has clients that are RICs, such policies and procedures will be disclosed to the RIC's Board of Trustees.

III. REQUEST FOR NO-ACTION RELIEF

As noted above, we believe the aggregation of orders generally benefits all participants because it may result in a lower overall execution cost, avoids having to place into the market competing orders in the same security, and helps the adviser maintain a "level playing field" when trading for its clients. We also believe that the representations below which, other than the representation regarding transaction costs, are largely based on the representations made in *SMC*, would ensure that the RICs, as well as other participants in the order, will continue to be treated fairly.

ICI therefore seeks the Staff's assurance that it would not recommend enforcement action if an investment adviser engages in the aggregation of client orders on the following basis:

1. Each account that participates in an aggregated order will participate at the average security price for all of the adviser's transactions in that security in accordance with the adviser's Allocation Statement and/or trade allocation policy, with execution costs shared *pro rata* based on participation in the transaction;

2. All trades will be subject to the adviser's duty of best execution, and total transaction costs for each client will continue to be subject to the adviser's good faith determination that the transaction costs are reasonable in relation to the value of the execution and research services;

3. The adviser will prepare, before entering an aggregated order, an Allocation Statement;

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[25] In accordance with the requirements of Form ADV, advisers will continue to disclose their practices relating to brokerage and the payment of research. *See* Form ADV Part 2A, Item 12 (requiring advisers to disclose their soft dollar practices, including whether clients may pay commissions higher than those obtainable from other brokers in return for the research and/or other products and services; whether research is used to service all accounts or just those accounts paying for it; and any procedures that the adviser used during the last fiscal year to direct client transactions to a particular broker in return for products, research and services received).

4. The adviser will adopt and maintain policies and procedures to address how orders will be aggregated and allocated among participating accounts. Such policies and procedures will be designed to ensure that all orders are aggregated and allocated in a manner that is consistent with the adviser's fiduciary duty and its representations and disclosures to clients;

5. If the aggregated order is filled in its entirety, it will be allocated among the accounts in accordance with the Allocation Statement and/or policies and procedures; if the order is partially filled, it will be allocated *pro rata* based on the Allocation Statement and/or policies and procedures. Notwithstanding the foregoing, the trade may be allocated on a basis different from a *pro rata* allocation if all participating accounts receive fair and equitable treatment and the reason for such different allocation is either specified by the policies and procedures or approved in writing by the adviser's compliance department no later than the next trading day;

6. The adviser's order aggregation policies and procedures will include periodic review, by one or more oversight committees that include the adviser's chief compliance officer or designee (or similar control function, such as Risk), designed to ensure that they are adequate to prevent any client from being systematically disadvantaged as a result of the aggregated orders and the subsequent allocation thereof. In the case of RICs, compliance with these policies and procedures would be reviewed at least annually by the RIC's Board of Trustees as part of, or in addition to, the Board's general oversight of the adviser's allocation of brokerage and its use and acquisition of research;[26]

7. Policies for aggregation of orders will be fully disclosed in the adviser's Form ADV and the RIC's Statement of Additional Information; and

8. The adviser's books and records will separately reflect, for each account of a client whose orders are aggregated, the securities held by, and bought and sold for, each account.

We believe that permitting aggregation of orders, as outlined above, is consistent with Section 17(d), Rule 17d-1 and Section 206.[27]

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[26] *See Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices*, Exch. Act Rel. No. 58264 (July 30, 2008).

[27] ICI is only requesting relief with respect to differences in transaction costs associated with varying research arrangements. Any other variations in costs associated with the aggregated order are outside the scope of this request.

IV. CONCLUSION

The aggregation of orders benefits all participants because it may result in lower execution costs and avoids having to submit competing orders into the marketplace. The ability to aggregate orders allows clients to receive a better share price and improved execution, but does not affect their arrangements for research, which are dictated by other requirements. We believe that the representations above would ensure that RICs, as well as other participants in the trade, will continue to be treated fairly.

For all the foregoing reasons, we respectfully request that the Staff grant the request for no-action relief set above. If you have any questions, please contact the undersigned at (202) 218-3563, Jennifer Choi, Associate General Counsel, at (202) 326-5876, or Eva Mykolenko, Associate Chief Counsel, at (202) 326-5837.

Sincerely,

/s/ Dorothy Donohue

Dorothy Donohue
Acting General Counsel