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October 17, 2017

Douglas J. Scheidt
Associate Director and Chief Counsel
United States Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: Relief from the Investment Advisers Act of 1940 for Broker-Dealers Receiving Payments for Research from Investment Managers Subject to MiFID II

Dear Mr. Scheidt:

On behalf of the Securities Industry and Financial Markets Association ("SIFMA"),[1] we request that the staff of the Division of Investment Management confirm that it will not recommend that the Securities and Exchange Commission ("SEC") take enforcement action under the Investment Advisers Act of 1940 ("Advisers Act") against certain broker-dealers that provide research services that constitute investment advice under Section 202(a)(11) to an investment manager that is required under the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, as implemented by the European Union ("EU") member states ("MiFID II"),[2] either directly or by contractual obligation, to pay for the research services from its own money,[3] from a research payment account ("RPA") funded with its clients' money, or a combination of the two. Specifically, the requested relief would cover broker-dealers that are registered with the SEC and certain foreign broker-dealers that are not registered with the SEC and are exempt from registration pursuant to Rule 15a-6 under the Securities Exchange Act of 1934

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1 SIFMA is the voice of the U.S. securities industry. SIFMA represents the broker-dealers, banks, and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets, and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit http://www.sifma.org.

2 Directive 2014/65, of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments and Amending Commission Directive 2002/92 and Council Directive 2011/61, O.J. (L 173) 57, 349, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2014:173:TOC.

3 An investment manager may delegate portfolio management to a non-EU domiciled investment manager and contractually require that manager to comply with MiFID II or equivalent protections (e.g., setting research budgets, accounting for research inputs, and having systems and controls to ensure that the receipt of research does not give rise to certain conflicts of interest). *See* Letter from Stephen Hanks, Financial Conduct Authority, to Jiri Krol, Deputy CEO, Alternative Investment Management Ass'n (July 19, 2017).

("Exchange Act").[4] The need for this no-action relief is urgent because of the impending January 3, 2018 implementation date for MiFID II.

SIFMA considers the requested relief important to address the potential for the new MiFID II requirements (which were adopted by EU regulators to address regulatory considerations involving EU investment managers) to negatively impact investors, the US capital markets, and the marketplace for research services in the US. Below we provide background on MiFID II, describe the challenges the MiFID II requirements create for broker-dealers doing business in the US, outline SIFMA's requested no-action relief, and explain the rationale behind the requested relief.

Background on MiFID II

MiFID II is an EU directive that, among other things, bans investment managers from receiving or retaining any inducements for conducting business, such as fees, commissions, or other monetary or non-monetary benefits, including "research," as defined under MiFID II.[5] Under MiFID II, an investment manager can receive research without it constituting an unlawful inducement if the investment manager pays for the research (1) directly out of its own money, (2) with client approval, from an RPA funded with its clients' money, or (3) a combination of the two.

An RPA differs somewhat from a client commission arrangement ("CCA") under the framework established by the SEC under Section 28(e) of the Exchange Act. In a CCA, an investment manager pays a bundled payment for brokerage and research services, and a portion of that bundled payment is used to pay for research services. In comparison, an RPA is funded through a research charge assessed to the client based on an agreed-upon research budget, which can be separate cash contributions by the client or charges imposed and debited on a trade-by-trade basis alongside payments for execution, but not linked to the volume or value of transactions executed on behalf of the client.[6]

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[4] Specifically, the requested relief would cover non-US broker-dealers, including affiliates of SEC-registered broker-dealers, that are not registered with the SEC in reliance on Exchange Act Rule 15a-6 and that meet the conditions of paragraph (a)(2) of the rule or the SEC's position on distribution of research in Exchange Act Release No. 25801 and the adopting release for Rule 15a-6, as supplemented by subsequent guidance. *See* Registration Requirements for Foreign Broker-Dealers, Securities Exchange Act Release No. 27017 (July 11, 1989), 54 Fed. Reg. 30013 (July 18, 1989) (adopting Rule 15a-6) [hereinafter Rule 15a-6 Adopting Release].

[5] Recital 28 of the Delegated Directive states:

> Research in this context should be understood as covering research material or services concerning one or several financial instruments or other assets, or the issuers or potential issuers of financial instruments, or be closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector. That type of material or services explicitly or implicitly recommends or suggests an investment strategy and provides a substantiated opinion as to the present or future value or price of such instruments or assets, or otherwise contains analysis and original insights and reach conclusions based on new or existing information that could be used to inform an investment strategy and be relevant and capable of adding value to the investment firm's decisions on behalf of clients being charged for that research.

Commission Delegated Directive of July 4, 2016 Supplementing Directive 2014/65/EU. MiFID II includes a narrow exception from the ban on inducements for "minor non-monetary benefits."

[6] An investment manager that uses an RPA to purchase research must meet certain requirements, including that the investment manager (1) funds the RPA with a research charge to the client that has been agreed to with

Challenges MiFID II's Requirements Create for Broker-Dealers

While an EU directive, MiFID II is expected to impact broker-dealers given the global nature of the US capital markets and the reliance by non-US and global investment managers on research services provided by broker-dealers. As a result, US broker-dealers (and their EU broker-dealer affiliates) that provide research services[7] to investment managers subject to MiFID II can expect to receive separate payments for those research services.[8] SIFMA is concerned that the receipt of payments for research services directly or indirectly out of an investment manager's own money or from an RPA might inadvertently subject broker-dealers' research services to the Advisers Act by creating questions about their ability to rely on the longstanding broker-dealer exclusion, and thereby disrupt existing business models that are already subject to a comprehensive regulatory framework overseen by the SEC and the Financial Industry Regulatory Authority ("FINRA"), as discussed below.[9] Any result that would subject broker-dealers to the Advisers Act regulatory framework when providing research services, including restrictions on agency and principal trading in Section 206(3), would be unnecessary in this context given the existing comprehensive regulatory framework governing research services provided by broker-dealers and could disrupt a broker-dealer's role in providing liquidity and acting as counterparty to its clients. SIFMA believes this would create significant uncertainty and likely substantial business disruption as broker-dealers try to assess the impact on their brokerage and research services. Accordingly, relief is needed for broker-dealers to continue to avail themselves of the Advisers Act exclusion when providing research services to investment managers subject to MiFID II lest they cease to provide or curtail the provision of research services to those investment managers.[10]

As discussed below, broker-dealers are subject to extensive regulation when providing research, including independence in the development of research, consistency in the dissemination of research, and separation of research from investment banking and trading in various important ways. Within this

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each client; (2) sets and regularly assesses a research budget, with any surplus refunded to clients or used to offset future research costs; (3) regularly assesses the quality of the research received; (4) provides clients and EU regulators, upon request, certain information about the use of the RPA to purchase research; and (5) establishes a written policy addressing how research purchased through the RPA will be used to benefit clients' portfolios and how the costs will be allocated among clients.

[7] For purposes of illustration, the types of content and related services provided by broker-dealers that could constitute "research" for purposes of MiFID II and also be considered "investment advice" for purposes of the Advisers Act include research reports (within the contemplation of Regulation AC and FINRA Rules 2241 and 2242), related research models, sales and trading commentary, other related services (e.g., alpha capture, trading ideas, bespoke analysis, and other services), and interaction with research analysts and sales and trading personnel (e.g., where those interactions involve advice on issuers, trading ideas, bespoke analysis, etc.).

[8] Payments for research services might be made directly by an investment manager subject to MiFID, directly or by contractual obligation, or by a US affiliate on behalf of the investment manager.

[9] Although a broker-dealer should be deemed to receive commissions – and not "special compensation" under Section 202(a)(11)(C) – when receiving commissions under a CCA operating under SEC interpretations of Section 28(e) of the Exchange Act, SIFMA members are concerned that, because the contours of what constitutes "special compensation" is not necessarily clear in the context of research services, the SEC or its staff might view a broker-dealer as receiving "special compensation" for investment advice if it receives payments for research services directly or indirectly out of an investment manager's own money, from an RPA funded with the investment manager's clients' money, or a combination of the two.

[10] *See* Letter from Jay Clayton, Chairman, SEC, to The Honorable Thom Tillis, U.S. Senate (Sept. 14, 2017).

framework, research, sales, and trading services are often provided in a coordinated way to provide investment managers with information about securities and the markets that brings together the collective expertise and varied perspectives of research, sales, and trading personnel. Although a broker-dealer could explore providing research services as an investment adviser – either through a dedicated division or a separate entity – doing so presents many significant legal and practical challenges for many of the largest broker-dealers participating in the US and global capital markets because interactions with investment managers often involve a combination of research, sales, and trading touchpoints.[11] First, the limitations on agency and principal trading in Section 206(3) might not be confined to the investment adviser providing research services. The SEC and its staff have taken the position that Section 206(3) applies not just to an investment adviser but also to certain situations in which an adviser causes a client to enter into a principal or agency transaction that is effected by a broker-dealer that controls, is controlled by, or is under common control with the adviser.[12]

Second, because research services may be provided to investment managers in interactions that also involve sales and trading, separating research activities performed as an investment adviser from sales and trading activities performed as a broker-dealer would present legal and practical challenges that could diminish the value of these services. A broker-dealer might explore registering its research business unit as an investment adviser and trying to ring-fence that business unit from the sales and trading business units. To do this, a firm might impose additional barriers between its research and sales and trading businesses in order to segregate its investment advisory activities from its broker-dealer activities.[13] While this approach might be appealing to address uncertainties concerning potential adviser status, it would be challenging and, for many firms, unworkable where interactions with investment managers involve a combination of research, sales, and trading activities. It could also impose substantial operational complexity and expenses on broker-dealers and investment managers, for example, by requiring them to significantly expand monitoring of all interactions with investment managers to ensure compliance with the Advisers Act, including Section 206(3), and other laws.

Requested No-Action Relief

As indicated at the outset, SIFMA seeks assurance that the staff will not recommend that the SEC take enforcement action under the Advisers Act against a broker-dealer that provides research services that constitute investment advice under Section 202(a)(11) of the Advisers Act to an investment manager that is required under MiFID II, either directly or by contractual obligation, to pay for the research services

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11 Firms may provide research services through separate research, sales, and trading business units, all of which might be deemed research under MiFID II and investment advice under the Advisers Act. The research business unit generally distributes research reports (within the contemplation of Regulation AC and FINRA Rules 2241 and 2242) that are prepared by its research analysts. The research analysts also might interact with investment managers. The sales and trading business units produce sales and trading commentary and other related services (e.g., alpha capture, trading ideas, bespoke analysis, and other services), and sales and trading personnel also interact with investment managers.

12 *See* Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1732 (July 17, 1998), 63 Fed. Reg. 39505 (July 23, 1998); Hartzmark & Co., SEC Staff No-Action Letter (pub. avail. Nov. 11, 1973) (applying Section 206(3) when an adviser effects transactions through its broker-dealer parent).

13 The SEC and FINRA have adopted rules designed to ensure the independence and objectivity of analysts in the preparation of research reports (e.g., Regulation AC under the Exchange Act and FINRA Rules 2241 and 2242) while not prohibiting interaction between analysts and sales and trading personnel.

from its own money, from an RPA funded with its clients' money, or a combination of the two.[14] The requested no-action relief would be limited only to those situations where a broker-dealer receives payments from an investment manager subject to MiFID II, either directly or by contractual obligation.[15] For purposes of this relief, a non-EU-domiciled investment manager ("Non-EU Manager") would be treated as subject to MiFID II by contractual obligation where an investment manager directly subject to MiFID II directly or indirectly delegates portfolio management to the Non-EU Manager and the Non-EU Manager is contractually required to comply with MiFID II or equivalent protections (e.g., setting research budgets, accounting for research inputs, and having systems and controls to ensure that the receipt of research does not give rise to certain conflicts of interest) in managing accounts under the delegation.[16]

The core principles underpinning this request are two-fold. First, the receipt of payments from an investment manager's own money or an RPA mechanism, and the central requirement of pricing the research and execution elements of a commission separately, are dictated by circumstances outside of the broker-dealer's control – here, the requirements of MiFID II – that reflect regulatory or business decisions made outside the US that are inconsistent with the long-standing approach under the US federal securities laws. Second, MiFID II's unbundling requirements do not change the underlying nature of the relationship between broker-dealers and investment managers or the research services provided by broker-dealers, which are already subject to comprehensive regulation under the broker-dealer regulatory framework in the US. While granting this relief now is critical in light of the impending January 3, 2018 implementation date for MiFID II, SIFMA believes the SEC will ultimately need to monitor the evolving market and regulatory landscape for research services and trade execution, and provide further relief as needed to address incompatibilities that develop between the US federal securities laws, including the Advisers Act, and the laws and practices in other jurisdictions that make up the global securities markets.[17]

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[14] SIFMA believes a broker-dealer should be able to rely on the relief regardless of whether payments for research services are paid directly to the broker-dealer or indirectly through a non-US broker-dealer affiliate that shares the payments with the broker-dealer, or whether the broker-dealer has a trading relationship with the investment manager. Moreover, we ask that the requested relief extend to dealings with investment managers domiciled in the United Kingdom ("UK") following Brexit without the need to request additional relief from the SEC or its staff because the UK Financial Conduct Authority ("FCA") has announced its intention of transposing MiFID II into UK law, and we anticipate the FCA will impose the MiFID II unbundling requirements following Brexit.

[15] The requested relief would also cover non-US broker-dealers, including affiliates of SEC-registered broker-dealers, that are not registered with the SEC in reliance on Exchange Act Rule 15a-6 and that meet the conditions of paragraph (a)(2) of the rule or the SEC's position on distribution of research in Exchange Act Release No. 25801 and the adopting release for Rule 15a-6, as supplemented by subsequent guidance. *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30013.

[16] We are requesting this relief where there is a nexus to the EU and therefore MiFID II's requirements. In other words, the investment manager making the payments for research services must be either domiciled in the EU, and thus directly subject to MiFID II, or domiciled elsewhere and contractually required to comply with MiFID II or equivalent protections (e.g., setting research budgets, accounting for research inputs, and having systems and controls to ensure that the receipt of research does not give rise to certain conflicts of interest). *See* Letter from Stephen Hanks, Financial Conduct Authority, to Jiri Krol, Deputy CEO, Alternative Investment Management Ass'n (July 19, 2017). This includes situations where an investment manager domiciled in the US makes payments for research services to a non-US broker that provides research to the US investment manager in reliance on Exchange Act Rule 15a-6.

[17] SIFMA believes the core principles underlying this relief – that the form of payment for research services is dictated by circumstances outside of the broker-dealer's control and does not change the broker-dealer's relationship

Rationale for the Requested Relief

As the SEC has long acknowledged, "investment research is a fundamental element of the brokerage function."[18] The Supreme Court has also recognized that the ability of research analysts to question corporate insiders and to "ferret out and analyze information" is necessary to the preservation of a healthy market.[19] The policy determinations made by Congress under the US federal securities laws recognize the importance of research services as an incident to brokerage activity and provide a safe harbor for investment advisers purchasing research services through combined payments for research and execution. The SEC has also long recognized the key role broker-dealers play in providing advice, such as research services and access to analysts, as an incident of brokerage services.[20]

Notably, the importance of broker-dealer research services was affirmed in the 1970s when fixed commission rates were eliminated, both by Congress in enacting Section 28(e) of the Exchange Act to preserve the ability of US investment managers to pay commissions for research services and by the SEC in temporarily exempting certain broker-dealers from the Advisers Act while the SEC evaluated the transition to competitive commission rates and the transition to the framework established by Section 28(e).[21] Since then, we believe that the SEC has done an important job of recognizing changes in the global markets when interpreting Section 28(e), including 2006 guidance relating to the evolution of CCAs.[22] The SEC has provided needed flexibility to both investment managers and broker-dealers to structure compensation arrangements for research services, including through CCAs, in a way that preserves the accessibility of research services.

SIFMA is concerned that the impending implementation of MiFID II, without corresponding clarity from the SEC that US and certain non-US broker-dealers can accept MiFID II-compliant payments for research services without triggering the Advisers Act, will negatively impact investors, the US capital markets, and the marketplace for research services in the US. MIFID II's requirement that EU investment managers

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with the investment manager or the research services provided – should inform how the SEC staff approaches similar circumstances involving payments for research services. SIFMA hopes the staff of the Division of Investment Management would respond favorably to no-action requests by broker-dealers where receiving payments for research services under similar circumstances.

18 Future Structure of Securities Markets, 37 Fed. Reg. 5286, 5290 (Mar. 14, 1972).

19 *Dirks v. SEC*, 463 U.S. 646, 657 (1983) ("The SEC expressly recognized that '[t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.'") (quoting 21 S.E.C. Docket 1401, 1406 (1981)).

20 *See, e.g.*, Certain Broker-Dealers Deemed Not To Be Investment Advisers, Investment Advisers Act Release No. 2376 (Apr. 12, 2005), 70 Fed. Reg. 20424 (Apr. 19, 2005) (discussing generally, in the adopting release for since-vacated Advisers Act Rule 202(a)(11)-1, the historical role of broker-dealers providing investment advice among the overall package of services provided to customers).

21 *See* Adoption of Temporary Exemption from the Advisers Act and the Rules and Regulations Thereunder for Certain Brokers and Dealers, Investment Advisers Act Release No. 455 (Apr. 23, 1975), 40 Fed. Reg. 18424 (Apr. 28, 1975) (adopting Advisers Act Rule 206A-1T to temporarily exempt certain broker-dealers from the Advisers Act following the elimination of fixed commission rates).

22 *See* Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Securities Exchange Act Release No. 54165 (July 18, 2006), 71 Fed. Reg. 41978 (July 24, 2006).

price the research and execution elements of a commission separately and the issues this requirement raises under the Advisers Act for broker-dealers are already creating uncertainty among the industry. Given the centrality of the US capital markets to the global economy, any disruption caused as a result of broker-dealers trying to comply with the MiFID II requirements could have significant U.S. and global consequences. Subjecting broker-dealers to the Advisers Act when providing research services could disproportionately impact smaller issuers to the extent research coverage is reduced. It could also limit broker-dealers' ability to trade on an agency or principal basis with those investment managers, which could impact liquidity most notably in the fixed income market, where most trades occur on a principal basis.[23]

SIFMA believes the requested relief is appropriately tailored to address the hurdles that could prevent investment managers subject to MiFID II from accessing US research services and concerns that broker-dealers would be placed at a competitive disadvantage vis-à-vis their European competitors when doing business with EU investment managers to the extent they might be subject to an additional layer of regulation under the Advisers Act – indeed, one that would impede their ability to provide liquidity or act as counterparty in transactions, which is fundamental to the US capital markets. In SIFMA's view, these drawbacks outweigh any potential benefits of imposing the Advisers Act on broker-dealers providing research services, particularly since MiFID II's requirement that investment managers price the research and execution elements of a commission separately does not change the underlying nature of the relationship between broker-dealers and investment managers or the research services broker-dealers provide.

SEC-registered broker-dealers are already subject to comprehensive regulation that addresses conflicts of interest and other issues in providing research services. The regulatory framework governing broker-dealers providing research services has strengthened since 1972, when the SEC recognized that "the providing of investment research is a fundamental element of the brokerage function for which the bona fide expenditure of the beneficiary's funds is completely appropriate, whether in the form of higher commissions or outright cash payments."[24] For example, Regulation AC under the Exchange Act and FINRA Rules 2241 and 2242 establish requirements for broker-dealers in managing conflicts of interest in the preparation and dissemination of research reports.[25] In addition, FINRA Rule 5280 prohibits broker-dealers from trading in a security or a derivative of a security based on non-public advance knowledge of the timing or content of a research report, and requires broker-dealers to establish, maintain, and enforce policies and procedures reasonably designed to prevent trading ahead of research reports.[26] Moreover, broker-dealers are subject to anti-fraud provisions under the Securities Act of 1933 and the Exchange Act, as well as FINRA rules, in providing research services, including interactions with trading clients.

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[23] For example, a broker-dealer might not know at the time of any trades whether it will receive cash payments from the investment manager for research services such that the broker-dealer might be deemed to have acted as an investment adviser in relation to the trades, and thus required to obtain client consent to act as principal in the trades under Section 206(3) of the Advisers Act.

[24] Future Structure of the Securities Markets, 37 Fed. Reg. 5286, 5290 (Mar. 14, 1972).

[25] *See* Regulation Analyst Certification, Securities Exchange Act Release No. 47384 (Feb. 20, 2003), 68 Fed. Reg. 9482 (Feb. 27, 2003); FINRA Rule 2241 (Research Analysts and Research Reports); FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports); *see also* FINRA Rule 2210 (Communications with the Public).

[26] FINRA Rule 5280 (Trading Ahead of Research Reports).

Although our requested relief also covers non-US broker-dealers that are exempt from broker-dealer registration requirements and therefore not subject to broker-dealer regulatory requirements governing research, the SEC and its staff have concluded that public policy considerations did not warrant extending Exchange Act and Advisers Act regulatory requirements to non-US broker-dealers where they meet the conditions of paragraph (a)(2) of Rule 15a-6.[27] Rule 15a-6 and related SEC and staff guidance permit non-US broker-dealers not registered with the SEC to provide research to "major US institutional investors" (as defined to include investment advisers, whether or not registered under the Advisers Act, with assets under management in excess of $100 million) and other U.S. persons where the research is distributed by an SEC-registered broker-dealer that accepts responsibility for the research and the research states that orders should be effected through the SEC-registered broker-dealer.[28] In addition, when adopting Rule 15a-6, the SEC noted that if the proposed conditions are met, the direct distribution of research to qualified investors would be consistent with the free flow of information across national boundaries without raising substantial investor protection concerns.[29]

SIFMA does not believe it is necessary or appropriate in this context to overlay the Advisers Act framework on top of the existing comprehensive broker-dealer regulatory framework applicable to research services.

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In light of the foregoing, we seek your confirmation that the staff of the Division of Investment Management will not recommend enforcement action to the SEC in the circumstances set forth above.

We welcome the opportunity to discuss this request with you. If you have any questions, please feel free to call me at (202) 739-5453 or my colleague Brian J. Baltz at (202) 739-5665. On behalf of SIFMA, we appreciate the staff's consideration of this request.

Yours truly,

Steven W. Stone

cc: The Honorable Jay Clayton, Chairman
The Honorable Michael S. Piwowar, Commissioner
The Honorable Kara M. Stein, Commissioner
Dalia Blass, Director, Division of Investment Management

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27 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. at 30023; *see, e.g.,* Barclays PLC, SEC Staff No-Action Letter (Feb. 14, 1991); Dean Witter Reynolds (Canada) Inc., SEC Staff No-Action Letter (Mar. 1, 1990); James Capel & Co., Limited, SEC Staff No-Action Letter (Dec. 6, 1989); Brown Shipley Stockbroking Limited, SEC Staff No-Action Letter (Dec. 6, 1989).

28 *See* 15a-6 Adopting Release at 30022.

29 *Id.* at 30021.

Heather Seidel, Acting Director, Division of Trading and Markets
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