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SEC's Hard Turn on Hard Dollars

By Wayne M. Aaron

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On July 26, 2022, William Birdthistle, the Director of the SEC's Division of Market Regulation, indicated in remarks at an industry conference that the SEC would not extend the no-action relief previously given to align the U.S. regulatory framework on soft dollar arrangements with the framework of the European Union (the "EU") under the EU's Markets in Financial Instruments Directive ("MiFID II").[1] Under the previous relief,[2] issued in 2017 and extended in 2019 until July 2023, a broker-dealer could receive a hard-dollar payment for research provided pursuant to a soft-dollar arrangement under the safe harbor of Section 28(e) under the Securities Exchange Act of 1934, as amended.

Under MiFID II and the substantially similar rules of EU member states, an investment manager cannot receive an "inducement" from a third party, which includes the provision of research.[3] MiFID II provides a framework for an investment manager to avoid this prohibition, by making payment for research from a "research payment account" funded by the manager from the manager's own funds, from client money with the client's approval, or from a mix of the two. For practical reasons, most managers subject to the EU framework elect to make payment from their own funds. That is, they pay for the research with hard dollars. Further, hard-dollar payments encourage "unbundling" of research from brokerage, with the investment manager valuing the research separately from brokerage and paying for the research separately, often from a broker-dealer research provider that is different from the executing broker.

The MiFID II hard-dollar payment approach creates a conflict with U.S. securities laws, particularly when the research provider is a U.S. broker-dealer. A broker-dealer providing investment advice (such as research) is not required to register as an investment adviser if it does so "solely incidental" to its provision of brokerage services and "receives no special compensation therefor."[4] The receipt of a hard-dollar payment can be viewed as such "special compensation," thereby making the exception of investment adviser registration unavailable and potentially requiring the broker-dealer to be registered also as an investment adviser. Such dual registration would also trigger the application of routine Advisers Act provisions, such as the disclosure and consent provisions for principal transactions with managed account and agency cross transactions under Section 206(3) under the Advisers Act.

The No-Action Letters provided relief from the registration requirement, determining that a broker-dealer would not need to register as an investment adviser as a result of receiving hard-dollar payments consistent with the MiFID II framework from investment managers subject to MiFID II.[5]

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[1] William Birdthistle, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Remarks at PLI: Investment Management 2022 (July 26, 2022), available at: https://www.sec.gov/news/speech/birdthistle-remarks-pli-investment-management-2022-072622.

[2] See Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (Oct. 26, 2017) and Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (Nov. 26, 2019) (collectively, the "No-Action Letters").

[3] See 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/EC and Council Directive 2011/61/EU, available at https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32014L0065).

[4] Section 202(a)(11) of the Investment Advisers Act of 1940, as amended (the "Advisers Act").

[5] Note that the relief was only available for payment from managers subject to MiFID II. The No-Action Letters provided no relief for receipt of hard-dollar payments from a U.S. investment adviser not otherwise subject to MiFID II.

Director Birdthistle's statement changes the regulatory landscape. When the existing relief expires on July 3, 2023, a broker-dealer that is not a dual registrant will be unable to accept hard-dollar payments from EU investment managers without registering as an investment adviser. According to Director Birdthistle, the SEC is "making our intentions [on non-renewal] known well in advance of [the] July 2023 [expiration] to allow ample time to address any issue." It is not clear how or whether the SEC might seek to resolve any issues, as the SEC appears to believe (rightly or wrongly) that the marketplace has sorted the issue itself. Birdthistle claims in his speech that "firms have developed a variety of solutions to address the impact of MiFID II." But the "solutions" he describes are anything but, and far fewer than a "variety": "[s]ome broker-dealers have dually registered as investment advisers" and others use "a registered investment adviser affiliate to provide certain research services." The only solution, therefore, is to register as an investment adviser or provide such research through an already registered investment adviser.

The SEC's stance oddly elevates form over substance, permitting "compensation" in the form of soft dollars while rejecting (and requiring registration in the case of) "compensation" through hard dollars. In fact, Director Birdthistle made clear that the decision not to extend the adviser registration exemption does not affect other statements or relief in the No-Action Letters which expressly "are not being rescinded." Among those are the SEC's statements in the 2019 No-Action Letter that the framework for unbundling brokerage and research in the SEC's 2006 interpretive release, where an executing broker shares commissions with a research-providing broker, and using soft dollars to pay that research-providing broker would not require the research-providing broker to register as an investment adviser.[6]

So where does the SEC's current stance leave broker-dealers and the EU-based investment managers that want to receive their research? The options are limited and not terribly appealing:

- **First**, the broker-dealer can provide the research from an entity that is a registered investment adviser. The downside to this approach is that the research business would need to be conducted fully within this entity and it may not be feasible to do so for operational or other reasons. A **related alternative** is registering the broker-dealer research provider as an investment adviser. This, of course, would subject the dual registrant to an additional layer of regulation and trigger additional requirements, such as those relating to principal and agency cross transactions under Section 206(3) of the Advisers Act.

- **Second**, the manager and the broker-dealer can unbundle the research expense through a commission sharing arrangement as described in the SEC's 2006 Interpretive Release. This serves to unbundle, and determine the applicable price for, the research, which helps inform the manager of the market value of the research. Unfortunately, the research broker can only be compensated for the research through the soft dollars generated through the commission sharing process, which is clearly difficult for an EU-based investment manager that would need to seek client approval for such payments through a research payment account.

The SEC's decision not to extend the 2017 relief is unfortunate and does not appear designed to address any issues identified while the relief was in place. It also increases the friction between two regulatory schemes, rather than recognizing and supporting the "globalization of the world's financial markets" and the fact that market participants operate across geographic borders,[7] as the SEC expressly did in the 2006 Interpretive Release.

If you would like to discuss the SEC's current approach to soft-dollar arrangements, the broker-dealer exemption to investment adviser registration, or other issues relating to Director Birdthistle's statements, please contact **Wayne M. Aaron** at waaron@vedderprice.com or the Vedder Price lawyer(s) with whom you normally work.

[6] See Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (Nov. 26, 2019) at n.8 ("Therefore, the staff believes that the use of [such arrangements] does not affect whether the broker-dealer exclusion may be available in connection with the receipt of payment for research under section 28(e)"). The framework of sharing commissions between an executing broker and a research broker is set forth in the SEC 2006 interpretive release. See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934 (July 18, 2006) ("2006 Interpretive Release") at 57, https://www.sec.gov/rules/interp/2006/34-54165.pdf.

[7] 2006 Interpretive Release, at 20.