Fund board MiFID II questions answered

By K. Susan Grafton and Christine Ayako Schleppegrell

Boards still have many questions about the EU's MiFID II requirements to unbundle research and execution costs

Following the Jan. 3 effective date of the EU's Markets in Financial Instruments Directive II, some fund boards are reviewing managers' responses to the new requirements.

MiFID II is legislation that impacts the ability of asset managers with a physical presence or domicile in the EU to receive and pay for research provided by investment banks, brokers and independent research providers. Specifically, MiFID II bans EU investment managers from accepting and retaining inducements (ie, fees, commissions or monetary or non-monetary benefits) from third parties relating to their provision of portfolio management services to clients. As a result, investment advisers subject to MiFID II can no longer receive research through soft dollar arrangements. Trustees may have the following questions about MiFID II:

1. Does MiFID II apply to US-registered investment companies and investment advisers?

a. MiFID II applies to investment firms that are located or domiciled in the EU or otherwise under contract to comply with MiFID II. Also, MiFID II compliance may be required when a US adviser uses EU subadvisers or when a US adviser serves as a subadviser to an EU fund. MiFID II does not apply to US advisers that do not have an EU place of business simply because they have clients located in the EU.

2. How does MiFID II change the way in which entities subject to the regulation pay for and receive research?

a. MiFID II essentially prohibits an investment adviser from using traditional soft dollar arrangements, including commission sharing arrangements (also referred to in the US as client commission arrangements) previously recognized by the Financial Services Authority, where the adviser may cause a client account to pay in excess of the lowest available commission that would be paid to a broker-dealer in exchange for research services and products. Instead, MiFID II mandates the unbundling of research and execution costs by requiring an investment adviser to pay for research using hard dollars (i) out of its own resources; or (ii) through client-funded research payment accounts controlled by the investment firm, subject to certain requirements.

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3. What is an RPA?

a. RPAs are accounts that are funded by each client and are subject to a research budget that is regularly re-assessed. An RPA can be funded indirectly (from payments made alongside brokerage transactions) or directly (from a client as a separate research charge). If the former option is used, the amount of the research charge cannot be linked to, and must be divorced from the volume or value of client transactions processed through the broker. Under the MiFID II regime, the client would need to consent to a charge for research. Firms choosing to use an RPA can still pay for both research and execution in a single transaction. However, firms must separate the cost of research and execution. This is different from soft dollar arrangements.

4. Are there differences between RPAs and CSAs?

a. Generally, RPAs are substantially similar to CSAs, and the distinction between an RPA and CSA is largely one of form over substance. Both RPAs and CSAs allow a portion of each commission to be held by the broker to fund research. The difference between RPAs and CSAs, therefore, is not whether the payments are unbundled, but when the unbundling takes place. In the case of an RPA, it is prior to trade execution, whereas, in the case of a CSA, it is after trade execution. However, in the case of a CSA, the investment adviser and the broker often negotiate the terms of the unbundling (ie, the crediting ratio) prior to trade execution even though the unbundling does not take place until after execution.

b. In a 2006 interpretive release, the Securities and Exchange Commission expanded its prior interpretation of the scope of the Securities Exchange Act of 1934, Section 28(e) safe harbor to include payments made in connection with CSAs. In a typical CSA model, an investment adviser causes a client account to pay a single, bundled commission to a broker for execution and research. The broker then credits a portion of the commission for research to a CSA administered by the broker, or transmits a portion of the commission to an external aggregator, and retains the remainder of the commission for execution. In the 2006 interpretive release, the SEC also expressed its openness to different types of commission arrangements, including those where an investment adviser executes trades with one broker, but obtains research from another as well as arrangements where an introducing broker facilitates access to research, but has a small or no role in trade execution or clearing. In a no-action letter to Goldman Sachs, the SEC staff provided further guidance on commission arrangements by laying out a framework for soft dollar aggregators and stating that it would not pursue enforcement action against research service providers if they received payments for research out of a commission pool and the research providers did not register as broker-dealers.

5. What guidance has the SEC provided with respect to MiFID II compliance issues under US law?

a. On Oct. 26, 2017, the SEC staff, in three no-action letters, addressed MiFID II compliance issues that have impacted US broker-dealers and investment advisers.

b. Investment Company Institute letter: In a letter issued to the ICI, the SEC staff of the Division of Investment Management indicated that it would not recommend enforcement action where an investment adviser subject to MiFID II aggregates trades reflecting differing arrangements for payment for research for its clients, including registered investment companies, provided that, among other things, (i) execution costs (rather than transaction costs) are shared pro rata; and (ii) the investment adviser determines, in good faith, that each client's total transaction costs are reasonable in relation to the value of execution and research services received. Accordingly, the SEC staff has recognized that, provided that certain representations are made, including representations regarding an adviser's policies and procedures, the aggregation of trades would not raise the concerns Section 17(d) of the Investment Company Act of 1940 and Rule 17d-1 were designated to address. On its face, the ICI letter only provides relief to investment advisers directly subject to MiFID II.

c. Securities Industry and Financial Markets Association letter: In a letter issued to SIFMA, the SEC staff of the Division of Investment Management stated that it would not recommend enforcement action against a broker-dealer that provides research services that constitute investment advice to an investment adviser that is subject to MiFID II. This relief is temporary and will last for 30 months from the Jan. 3 implementation date, or July 3, 2020, unless otherwise extended or modified. The SIFMA letter applies to investment managers that are directly subject to MiFID II or who are contractually obligated to comply with MiFID II.

d. SIFMA Asset Management Group letter: In a letter issued to the SIFMA's AMG, the SEC staff of the Division of Trading and Markets stated that it would not recommend enforcement action against investment managers operating in reliance on the Section 28(e) safe harbor if the manager pays for research through an RPA, provided that certain conditions are satisfied. Those conditions are (i) the investment adviser makes payments to the broker out of client assets for research alongside payments to that broker for execution; (ii) the research payments are for research services that are eligible for the safe harbor under Section 28(e); (iii) the broker effects the securities transaction for purposes of Section 28(e); and (iv) the broker is legally obligated by contract with the investment adviser to pay for research through the use of an RPA in connection with a CSA.

6. What questions should trustees pose to fund management?

a. Are the investment adviser and/or affiliates subject to MiFID II by law or contract?

b. If so, how are they complying?

c. What types of research or other services are received for these payments?

d. How much does the adviser/funds pay for research?

e. How much of that total amount is paid for by the funds?

f. What is the process for allocating both the research received and the research cost among individual funds?

g. Who from the adviser, compliance and/or the trading desk is overseeing the treatment of soft dollars and any necessary MiFID II compliance?

h. Has the adviser prepared and implemented new compliance policies and procedures related to any changes?

i. Can management provide a breakdown of the ratio of a broker's commission that is allocated to research versus execution? If the adviser has different systems for allocating research costs among different clients, how does the adviser track compliance for specific clients?

j. In connection with its MiFID II compliance efforts, will management enter into any new agreements that would require independent trustee or shareholder approval under Section 15 of the Investment Company Act?

k. How are these payments disclosed in the registration statement and any other SEC filings? Are updates required based on MiFID II?

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