

AUGUST 25, 2022

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Broker-Dealer Research: MiFID-Related "Hard Dollar" SEC Investment Adviser Status Relief to End in July 2023

I. SUMMARY

The EU Markets in Financial Instruments Directive II ("MiFID II"), which came into effect on January 3, 2018, raised concerns that U.S. broker-dealers that would receive "hard dollars" for research from firms subject to MiFID II could be classified as investment advisers under the U.S. Investment Advisers Act of 1940 (the "Advisers Act"). U.S.-registered broker-dealers have historically relied on an exception from the definition of "investment adviser" under the Advisers Act (in respect of research distribution) that is conditioned on (i) investment advice being incidental to the firm's broker-dealer business, and (ii) the broker-dealer not receiving "special compensation" therefor.¹ The conventional view is that "hard dollar" payments in exchange for securities research is "special compensation" for investment advice (*i.e.*, the investment research). A 2017 SEC Staff no-action letter provided temporary relief from this concern in respect of payments to broker-dealers from firms subject to MiFID II, and was later extended in 2019 until July 3, 2023.²

On July 26, 2022, William Birdthistle, Director of the SEC Division of Investment Management, indicated in a public speech³ that after July 3, 2023, U.S. broker-dealers accepting MiFID II compensation arrangements can no longer rely on the 2017 no-action letter to escape classification as an investment adviser.

II. BACKGROUND: MIFID II, HARD DOLLARS, AND THE ADVISERS ACT

Prior to MiFID II, investment managers regularly paid U.S. broker-dealers for research through "soft dollars" — bundled commission payments embedding the cost of other services, such as research. For businesses subject to EU jurisdiction, MiFID II addressed this, stating that unless an exemption is met, research that investment managers typically receive



from brokers is a prohibited “inducement.” To be exempt, the investment manager must pay for the research (i) directly from its own resources, (ii) from a “Research Payment Account” (RPA) funded with an advisory client’s money and with the client’s prior approval, or (iii) through a combination of the two methods. Many EU investment managers prefer the first option — paying directly from their own resources — which has reduced soft dollar use by EU-resident managers.

This reduction of soft dollar payments was a cause for concern for U.S.-registered broker-dealers, because the alternative — receipt of hard dollar payments for research — potentially triggers investment adviser status under the Advisers Act. On the one hand, receipt of soft dollar payments is within the exception from investment adviser status discussed above and found at Advisers Act Section 202(a)(11)(C) (soft dollars, being commissions, are not viewed as “special compensation” for investment advice) (the “Section 202(a)(11)(C) broker-dealer exclusion”).⁴ On the other hand, receipt of hard dollar payments for research calls into question the status of a broker-dealer seeking to rely on the Section 202(a)(11)(C) broker-dealer exclusion.

In response to the potential disruption of the broker-dealer research model, the SEC Staff issued a no-action letter in October 2017 providing temporary relief from enforcement actions under the Advisers Act. The relief applies to broker-dealers that provide research services that constitute investment advice to an investment manager that is subject, either directly or by contractual obligation, to MiFID II’s requirement to either pay for research services from its own money, from an RPA, or from a combination of the two. The no-action letter’s relief was set to expire on July 3, 2020, but on November 4, 2019 it was extended to July 3, 2023 (the letter granting such extension, the “2019 Extension Letter”).⁵

III. SUMMARY OF JULY 26, 2022 SPEECH

In the July 26, 2022 Speech, Director Birdthistle provided a more definite conclusion to the no-action letter. After July 3, 2023, a broker-dealer will not be able to accept hard dollar payments, including from firms subject to MiFID II requirements, in exchange for research in reliance on the Section 202(a)(11)(C) broker-dealer exclusion.

The 2019 Extension Letter also contained, in footnote 8, confirmation that broker-dealers would be eligible to rely on the Section 202(a)(11)(C) exclusion for receipt of commissions in connection with Client Commission Arrangements (“CCAs”), notwithstanding that the money manager in some cases (i) may not have a trading relationship with a broker-dealer that receives commissions for research from the CCA or (ii) to the extent it does have a trading relationship with such a broker-dealer, the trades may not relate to that broker-dealer’s research. In the July 26, 2022 speech, Director Birdthistle noted that this position will not be affected by the sunset of the MiFID II-related relief.

IV. IMPACT

Broker-dealers are provided just under a year (to July 3, 2023) to consider their posture regarding provision of research to MiFID firms that are required to pay hard dollars. Without the protection of the no-action letter they are faced with the potentially difficult decision to (i) risk investment adviser status through the continuing receipt of hard dollars for research, absent identification of a different means of avoidance of investment adviser status, or (ii) cease providing research to such firms in exchange for hard dollars.



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¹ Advisers Act Section 202(a)(11)(C).

² Securities Industry & Financial Markets Ass'n, SEC No-Action Letter (Oct. 26, 2017), <https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm>.

³ William Birdthistle, Remarks at PLI: Investment Management 2022, <https://www.sec.gov/news/speech/birdthistle-remarks-pli-investment-management-2022-072622>.

⁴ See Russell D. Sacks and Steven Blau, "Research and Research Analysts", PLI: Broker-Dealer Regulation (July 2022), at p. 17-11, available at https://plus.pli.edu/Details/Details?rows=10&fq=~2B~title_id~3A282B22~32789~2229~&fq=~2B~id~3A282B22~32789-CH17~2229~&facet=true&origin=title.

⁵ See Russell D. Sacks and Steven Blau, "Research and Research Analysts", PLI: Broker-Dealer Regulation (July 2022), at p. 17-15, available at https://plus.pli.edu/Details/Details?rows=10&fq=~2B~title_id~3A282B22~32789~2229~&fq=~2B~id~3A282B22~32789-CH17~2229~&facet=true&origin=title. The 2019 Extension Letter is available at <https://www.sec.gov/investment/sifma-110419>.