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Soft Dollars

Changing Regulations May Restrict Hedge Fund Managers' Use of Soft Dollars in Europe

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By Gerald T. Lins, *Voya Investment Management LLC*

Up until relatively recently, the regulatory landscape surrounding soft dollars – or "soft commissions" – had been generally settled in both the U.S. and Europe. The U.S. Securities and Exchange Commission (SEC) last gave comprehensive guidance in this area in 2006, while the various European regulatory regimes likewise followed separate approaches with long histories, but in general concordance with the U.S. approach.

The practice, both in Europe and the U.S., had generally been for hedge fund managers to obtain investment research and other brokerage services with client commissions. Broker-dealers typically provided hedge fund managers with either research generated by the broker-dealer in-house (so-called proprietary research) or with research generated by third parties that the broker-dealer obtained on the hedge fund manager's behalf. While requirements differed from country to country, the research usually needed to provide the hedge fund manager with appropriate assistance in managing client accounts, but did not need to be traced back to individual accounts; in other words, research obtained through the commissions from many client accounts did not need to be used on a pro rata basis for those particular accounts.

However, with the onset of the various Markets in Financial Instruments Directives (known as "MiFID I" and "MiFID II") and other European initiatives in the past several years, particularly in the United Kingdom, the prognosis for trading and research activities across Europe is in upheaval.

This article examines the U.S. and U.K. practices for using soft dollars/commissions. It then explores the changes under MiFID I and MiFID II to the use of soft commissions in the E.U. and next steps in this area. For more on soft dollars, see "U.K. Financial Conduct Authority Issues Feedback Statement Supporting Proposed E.U. Limits on Soft Dollars," Hedge Fund Law Report, Vol. 8, No. 9 (Mar. 5, 2015).

U.S. Practices

U.S. hedge fund managers can generally use client commissions to obtain research and brokerage services as long as they fit within Section 28(e) of the Securities Exchange Act of 1934 – often called the "Section 28(e) safe harbor." In obtaining research, the hedge fund manager must determine that the research provides lawful and appropriate assistance to the hedge fund manager in its investment decision-making process. In addition, Section 28(e) requires a hedge fund manager to make a good faith determination that the value of any research and brokerage services it receives is reasonable in relation to the amount of commissions paid.

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The SEC staff generally does not determine whether a hedge fund manager's receipt of a particular product or service is within Section 28(e), and the staff does not encourage no-action requests on specific products or services. In the staff's view, these determinations depend on the facts of each case, including the nature of the product or service, how the hedge fund manager intends to use it and the hedge fund manager's good faith determination under Section 28(e). However, the SEC has clarified that hardware and similar commercially available products are generally not considered research for purposes of Section 28(e).

In the past, hedge fund managers needed to execute client transactions with the broker-dealer providing the research (although the broker-dealer itself could purchase the research from an external entity for delivery to the hedge fund manager). However, in 2006, the SEC simplified matters and provided an alternative means by which hedge fund managers could execute transactions with one broker-dealer and obtain research and brokerages services from another broker-dealer that would receive a portion of the commissions. Under these arrangements, often called "commission-sharing agreements" or "client commission arrangements," the second broker-dealer (i.e., the broker-dealer providing the research or brokerage services) will be deemed to be "effecting" the transaction – and thus come within Section 28(e) – if it executes, clears or settles the trade or if it performs at least one of the following functions: (1) taking financial responsibility for customer trades; (2) maintaining records relating to customer trades; (3) monitoring and responding to customer comments concerning the trading process; or (4) monitoring trades and settlements.

In a typical client commission arrangement, the hedge fund manager enters into an agreement with the executing broker-dealer, under which the executing broker-dealer accumulates credits for the hedge fund manager based on its level of trading. These credits are negotiated and are essentially equal to the amount of the commissions in excess of a base commission rate. For example, the trader may designate certain trades (or a percentage of overall eligible trades) for client commission arrangements and indicate the portion of the trade(s) that goes to the research pool (e.g., out of 3 cents per share, 2 cents may be for the execution cost with the other 1 cent per share going toward research). At the direction of the hedge fund manager, these credits can be applied toward various forms of research or brokerage services provided to the hedge fund manager by external vendors. On a monthly or other periodic basis, the broker-dealer provides a report to the hedge fund manager detailing the trading and credits accumulated or used during the period. Under many arrangements, at the end of the year the unused credits may be carried over for a limited period of time (e.g., one or two years).

Hedge fund managers may find these types of client commission arrangements beneficial because they can separate the execution and research capabilities of different broker-dealers and obtain both. A hedge fund manager can concentrate trading with those broker-dealers that provide superior execution and similar capabilities (e.g., algorithmic trading, analytics, etc.), while obtaining research from other broker-dealers or research providers. As such, the use of client commission arrangements has rapidly increased in recent years.

As a practical matter, hedge fund managers in the U.S. generally need to ensure that they fully disclose their commission practices to clients and investors. This disclosure may be made in various formats, including Form ADV; an investment advisory contract; the investment company or private fund offering materials; or otherwise. In addition, many managers in the U.S. establish a trading or brokerage committee to oversee trading, soft dollar usage and potential conflicts of interest.

U.K. Practices

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Until relatively recently, soft commission arrangements in the U.K. were governed by rules and regulations of the Financial Services Authority (FSA), which regulated banking and investment businesses, including investment managers and advisers previously regulated by the Investment Management Regulatory Organization. However, the FSA's responsibilities are now divided between the Financial Conduct Authority (FCA) and the Prudential Regulation Authority.

After an extensive debate within the U.K. regulatory, asset management and brokerage communities, and comment on several FSA proposals and discussion papers, the FSA adopted revised rules governing soft commission and similar practices in July 2005. A number of these rules were later revised in May 2014. See "U.K. Financial Conduct Authority Clarifies Whether Hedge Fund Managers May Use Dealing Commissions to Pay for Substantive Research or Corporate Access," Hedge Fund Law Report, Vol. 7, No. 28 (Jul. 24, 2014).

Under the revised rules, an investment manager may not execute (i.e., through a broker or another person) customer orders and receive goods and services (in addition to execution) unless:

- the goods and services will reasonably assist the investment manager in the provision of services to the customers on whose behalf the orders are being executed;
- the transactions do not, and are not likely to, impair the investment manager's duty to act in its customers' best interests;
- the good or service is directly related to the execution of trades on behalf of customers or amounts to the provision of "substantive research;" and
- the investment manager makes adequate prior and periodic (at least once a year) disclosure to the customer as required.

With respect to goods and services relating to providing substantive research, the FCA would generally view the applicable requirements as being met if the research is capable of adding value to the investment manager's trading or investment decisions by providing new insights to the investment manager when making trading decisions for customers; represents original thought (i.e., not merely repackaging existing facts); has intellectual rigor and does not merely state what is commonplace or self-evident; and presents the investment manager with meaningful conclusions based on analysis or manipulation of data. In addition, the FCA has made clear that so-called "corporate access" (defined as a service of arranging or bringing about contact between an investment manager and an issuer or potential issuer) does not constitute substantive research or execution services.

The FCA has also stated that the following goods and services relating to execution or research would not be eligible for purchase with client commissions:

- Services relating to the valuation or performance measurement of portfolios;
- Computer hardware;
- Connectivity services such as electronic networks and dedicated telephone lines;
- Seminar fees;
- Corporate access services;
- Subscriptions for publications;
- Travel, accommodation or entertainment costs;
- Order and execution management systems;
- Office administrative computer software (e.g., word processing or accounting programs);
- Membership fees to professional associations;

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- Purchase or rental of standard office equipment or ancillary facilities;
- Employees' salaries;
- Direct money payments;
- Publicly available information; and
- Custody services relating to designated customer investments (other than those incidental to trade execution).

When a U.K. hedge fund manager enters into arrangements for the receipt of goods or services that relate to the execution of trades or provision of research, it must make both prior disclosure and periodic disclosure in a timely manner. This disclosure must include details of the goods or services that relate to the execution of trades and, where appropriate, the details of the goods and services that are attributable to the provision of research.

The FCA currently permits commission-sharing arrangements so long as the manager's clients understand the nature and purposes of the arrangement; the commission flows are properly disclosed; and the arrangement does not create an unmanageable conflict of interest for the hedge fund manager. The FCA expects the executing broker-dealer to receive sufficient information about the nature of the goods or services received or supplied before making a payment.

However, given the pending changes under MiFID II, the U.K. regulatory regime is poised to become more restrictive. Most notably, the FCA believes that commission-sharing arrangements may not be consistent with the likely changes under MiFID II – a stance with which some other regulators do not agree.

MiFID I and II

The landscape in the European Union is in a state of flux and on the verge of major changes. MiFID I, adopted in 2007, sets forth requirements for service providers to receive so-called "inducements." In general, Article 26(b) of the MiFID Implementing Directive requires that:

1. prior to providing investment or ancillary services, disclosure must be made of the existence, nature and amount of the fee, commission or benefit (or, where the amount cannot be ascertained, the method of calculating the amount);
2. the third-party payment must be designed to enhance the quality of the relevant service to the client; and
3. the third-party payment must not impair compliance with the firms' duty to act in the best interest of clients.

The general consensus among practitioners and regulators was that MiFID I did not restrict the well-established practice of hedge fund managers receiving investment research as a result of commissions paid to brokers for executing transactions for client accounts.

MiFID II, adopted in 2014, sought to constrain the use of inducements further by prohibiting an investment manager from accepting and retaining fees, commissions or any monetary or non-monetary benefit paid or provided by any third party in relation to providing services to clients. A key point of debate has been whether investment research and similar services received by a hedge fund manager could be considered an "inducement." Some argue that the concept of an

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inducement has never been intended to encompass research and similar services, but rather is aimed at cash and similar payments.

In late 2014, the European Securities and Market Authority (ESMA), the financial regulatory authority of the European Union, issued technical advice on the proposed MiFID II requirements. Among the key points in ESMA's technical advice are:

- *Monetary Third-Party Payments* – Independent investment advisers and portfolio managers must return to clients any monetary third-party payments received in relation to the services provided to those clients as soon as possible after receipt. These types of payments might include fees or commissions.
- *Minor Non-Monetary Benefits* – Investment firms providing independent investment advice and portfolio management may not receive non-monetary benefits that are not "minor." ESMA's technical advice recommends that the European Commission produce an exhaustive list of non-monetary benefits that can be considered "minor" and, thus, acceptable. Benefits would be considered minor when they are reasonable and proportionate, unlikely to influence behavior in a way that would be detrimental to the client's interest. Benefits might include information or documentation relating to a financial instrument or investment service; participation in relevant conferences, seminars and other training events; hospitality of a reasonable de minimis value (e.g., food and drink during a conference or business meeting); and any other benefits that ESMA might set forth in guidelines.
- *Payment for Investment Research* – Having virtually eliminated the potential to obtain research from client commissions, ESMA explained that the hedge fund manager could either pay for the research out of its own resources (which would likely require higher management fees) or from separate research payment accounts funded by special research charges to clients. In those situations where a separate research account was used, clients would need to be informed beforehand of the amount budgeted and the expected charges and afterward of the total costs incurred for third-party research. The research budget could not be based on the volume or value of transactions.

An outlier of ESMA's technical advice arises in the context of fixed income trading and research provided by fixed income broker-dealers and banks. Traditionally, there has been no commission for fixed income trades, but rather a mark-up or mark-down. While banks and broker-dealers may provide research and other services to hedge fund managers trading in the fixed income markets, the general stance has been that research is an ancillary part of the relationship, rather than a separate service. European regulators maintain that the research fee is built into the bid-ask spread for fixed income trades and are pushing to separate research and trading costs. They believe that, over time, such separation will create a more transparent market and reduce transaction costs.

For both fixed income and equity transactions, many in the industry dispute the logic of forcing research to be paid for separately, noting that, over many years, commissions and trading costs have consistently decreased. In addition, a number of potential adverse consequences have been highlighted, including a decrease in research coverage for certain companies, gradual consolidation of investment advisers and conflicting regulatory regimes between Europe and the U.S.

The industry and some regulators have expressed serious misgivings about ESMA's technical advice, particularly its views on minor non-monetary benefits and the process for paying for
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investment research. Assuming that ESMA's guidance on MiFID II is implemented, global hedge fund managers will face multiple challenges when operating in different jurisdictions. For example, when operating outside of the U.S., hedge fund managers may need to use only research payment accounts or their own assets in obtaining research, rather than client commissions. Likewise, depending on the final version of any ESMA guidance and the form in which various European jurisdictions implement it, commission-sharing agreements may no longer be feasible outside of the U.S. Indeed, it is possible that some hedge fund managers will consider moving their base of operations if it makes trading significantly easier.

Next Steps

ESMA is currently considering comments on its technical advice and thereafter will transmit final recommendations to the European Commission. The Commission plans to publish rules at some point in 2015, and final standards could be issued by year-end, taking effect in early 2017. At this stage, the Commission has developed preliminary rules generally following ESMA's recommendations, which are subject to changes pending adoption and implementation by the various European Union member states.

Above all, the industry is anxious for practical and comprehensive guidance in this area, to minimize disruption to clients and operations as well as to avoid conflicting regulation across regimes.

For more on MiFID II, see "Simmons & Simmons and Advise Technologies Provide Comprehensive Overview of MiFID II (Part One of Two)," in this issue.

Mr. Lins is the General Counsel of Voya Investment Management. He is also the co-author of Soft Dollars and Other Trading Activities (Thomson West, 2015).

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