Recommendation Submitted by the Market Structure Subcommittee of the SEC Investor Advisory Committee (IAC) for IAC Consideration and Approval
Structural Changes to the US Capital Markets
Re Investment Research in a Post-MiFID II World
(July 19, 2019)

Introduction:

In January 2018, the European Union ("EU") Markets in Financial Instruments Directive II ("MiFID II") unleashed major changes to the landscape of investment trading and research[1] ("Research") internationally. In essence, MiFID II caused EU asset managers and broker-dealers to unbundle the costs of trading from Research and mandated the associated transparency into the costs of each.[2]

In the US, the cost of trading and Research has traditionally been bundled together by broker-dealers and paid for with client trading commissions (in this context, colloquially called "soft dollars") without full transparency into the underlying cost of each. In other words, US asset managers have been permitted under US law (in reliance on the safe harbor provided by Congress in Section 28(e) of the Securities Exchange Act of 1934) to cause their client accounts to pay broker-dealers commissions that exceed the costs of trading execution alone, where doing so is reasonable given the value of the bundle of trade execution and Research received.[3]

Bundling was also common practice in the EU until January 2018, when MiFID II effectively ended the practice and created an inconsistency between the EU and US practice and regulatory frameworks. EU asset managers, and US asset managers for their EU clients, are now generally paying for Research for MiFID-covered accounts separately from trade execution (sometimes referred to as "hard dollars"), while US asset managers for their non-EU clients generally continue to pay for bundled trading and Research with soft dollars. Despite these hurdles, some US Asset Managers have succeeded in unbundling Research from trading.[4]

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[1] For the purposes of this letter, Research includes, but is not limited to, formal research reports typically provided by research units of broker-dealers and access to research analysts for one-one-one discussions, as well as guidance that emanates from trading units of broker-dealers (sometimes called "Sales & Trading"), including market color, alpha capture, trading ideas, bespoke analysis, and desk commentary.

[2] MiFID II forced EU asset managers to choose between (1) paying for research out of their own assets (sometimes referred to as "hard dollars"), (2) continuing to pay for research using client assets, but only if such payments are made from a previously budgeted "Research Payment Account," or (3) some combination of the two.

[3] In interpreting the safe harbor, the SEC has not clearly defined what is included in the category of Research nor what constitutes a reasonable cost for Research.

[4] *See, e.g.,* Statement of Amy McGarrity, Chief Investment Officer, Colorado Public Employees' Retirement Association, before the SEC Investor Advisory Committee (Mar. 28, 2019).

The unbundling of brokerage from Research raises significant issues under US law, as a US broker-dealer that receives hard dollar payments for Research could be deemed an Investment Adviser subject to regulation under the Investment Advisers Act of 1940 ("Advisers Act"). For broker-dealers, registration as an Investment Adviser can be accomplished on a business-line basis depending on the underlying service being provided. For example, US broker-dealers' investment management divisions must be registered as Investment Advisers and at least one US broker-dealer has registered its division that produces and publishes widely disseminated formal research reports. However, it is problematic for the Sales & Trading divisions of US broker-dealers to register as Investment Advisers and continue to provide research, such as market color, alpha capture, trading ideas, bespoke analysis, and desk commentary to their clients while being registered as an Investment Adviser. This is because the Advisers Act imposes fiduciary duties to clients that may be a mismatch with the services broker-dealers provide as capital market participants and as counterparties to those clients.[5]

The SEC Staff recognized these concerns and issued a temporary No-Action Letter (the "SIFMA No-Action Letter").[6] The letter enabled US broker-dealers to comply with the unbundling, transparency, and hard dollar payment provisions of MiFID II for their asset manager clients that are subject to MiFID II, without requiring regulation as an Investment Adviser, while the SEC and its Staff determine the best approach, both to this regulatory inconsistency and to the knock-on implications to the US capital markets ecosystem. However, in adopting the SIFMA No-Action Letter, the SEC included an expiration date, signaling that it was not intended as a final action. The Letter is scheduled to expire on July 3, 2020. In the interim, the SEC has requested members of the capital markets ecosystem to comment on these issues to help inform the SEC and its Staff on a way forward.

Over the course of the past year, individual members of the Investor Advisory Committee ("IAC") Market Structure Subcommittee have done extensive research and outreach on this topic. We have considered the letters submitted to the SEC and have spoken with a variety of legal specialists and market participants, including public pension funds, investment advisers and mutual funds, from small to large. We have spoken with investment banks, bulge-bracket firms, and small, mid-sized and specialized Research providers. We have spoken with numerous trade associations impacted by the capital markets ecosystem and have done extensive collateral research. On March 28th of this

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[5] *See, e.g.*, Letter from Kenneth E. Bentsen, Jr., President & CEO, SIFMA, to Chairman Jay Clayton, SEC (Mar. 21, 2019) ("Questions broker-dealers might need to analyze in deciding whether to provide research as an investment adviser include, for example: How would providing content generated from the research, sales, and trading businesses as an investment adviser impact capital markets activities?"); Letter from Steven W. Stone, Partner, Morgan, Lewis & Bockius LLP, to Douglas J. Scheidt, Assoc. Dir. & Chief Counsel, SEC (Oct. 17, 2017) ("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.").

[6] Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (pub. avail. Oct. 26, 2017).

year, the SEC IAC convened a panel on trends in the Research marketplace and potential regulatory implications,[7] which included representatives of a US Issuer, a mid-sized asset manager, a US public pension fund asset owner, a capital markets expert, and a public market research provider.

The end-result of these efforts made four things clear to us:

1. First, Research is an essential component of the capital markets ecosystem. Without a healthy Research marketplace, the ability of all companies – large and small – to raise capital would be seriously compromised, as would the ability of investors to diligently manage savings, investment, and retirement assets. A reduction of Research coverage has a knock-on effect on liquidity, which is also an essential component of our capital markets ecosystem;
2. Second, many US-based asset managers and asset owners desire the ability to unbundle trading from Research, but there are also many asset managers (running the gamut from small, mid-sized, to large asset managers) who believe that bundling is an important, cost-effective and efficient method of maximizing their investment process;
3. Third, many investment managers desire greater transparency into the costs of the Research they are receiving from broker-dealers on the one hand, and many asset owners, and representatives of investment management clients, desire both greater transparency into the costs of that Research when bundled with trade execution and a clear understanding that the Research paid for with their commission dollars benefits them;[8] and
4. Fourth, an SEC-based solution to addressing both the impacts of MiFID II on the US capital markets and developments in the US Research marketplace around bundling and unbundling of Research and trading commissions (and the related hard vs. soft dollar payment implications) is highly complex. There are multiple Acts, Rules, Regulations, Interpretive Releases, No-Action Letters, case law, etc. (collectively, "SEC Legal Authorities") that touch on these issues. Further, MiFID II and bundling/unbundling are only a piece of a highly complex puzzle with far-reaching implications for a myriad of market participants. It may be that there is no one-size-fits-all solution or magic bullet that addresses the tangle of regulatory implications on the one hand and interests of market participants on the other.

Recommendation:

The Dodd-Frank Act established the IAC to advise the Commission on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure,

[7] *See* March 28, 2019 Meeting of the Securities and Exchange Commission Investor Advisory Committee Agenda, *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac032819-agenda.htm.

[8] Letter from Healthy Markets Association, Council of Institutional Investors, and CFA Institute to SEC Chairman Jay Clayton, "Concerns Regarding Best Execution and Research Payments Issues" (June 26, 2019) ("Our members, who regularly work as fiduciaries for US retirement funds, endowments, foundations, and other asset owners, frequently do not know how much of their own assets are being used to pay for investment research, nor can they be confident that the research they are buying even benefits their funds."); Statement of Amy McGarrity

and initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace.[9]

Often, the SEC IAC is able to make a targeted recommendation to fulfill its mandate that is specific to a particular SEC Legal Authority. But in the case of Research, trading, unbundling, transparency, MiFID II, and the multiple SEC Legal Authorities that are related to these issues, we are instead recommending concepts with three guiding principles that we ask the SEC to prioritize as it seeks to devise solutions.

Concept 1 – Market Structure Recommendation: Considering both the importance of Research to the capital markets ecosystem and the trends in demands from some consumers of Research, **we recommend that consumers of Research *regardless of where they are located* be able to choose whether to purchase Research bundled or unbundled from trading**. Any new SEC Legal Authority facilitating unbundling should avoid subjecting broker-dealers who provide that Research to increased regulatory burdens that arise solely from the form of payment received, as those could curtail their ability or willingness to produce Research, while avoiding any undue relaxation of Advisers Act protections. We note that (a) Research is already regulated by a variety of SEC and FINRA Rules[10] and (b) several commenters have observed that the SEC has authority under the Advisers Act to provide relief for broker-dealers to receive hard dollar payments for Research.[11]

Concept 2 – Investor Protection Recommendation: We recognize, however, that many asset managers are likely to continue to choose to use client assets to pay for Research, even if barriers to unbundling are removed. Although the IAC is not making a *specific* recommendation at this time regarding *how* the Commission should act to provide greater transparency, as it relates to the costs of Research, and greater understanding that clients actually benefit from Research they pay for, we do believe these are vitally important priorities that should be addressed by the SEC as it determines how to respond to the scheduled expiration of the SIFMA No-Action Letter. [12] Toward that end, one option for the SEC to consider is whether fiduciaries relying on the Section 28(e) safe harbor should be required to provide greater transparency about any costs borne by clients in the form of

[9] Dodd-Frank Wall Street Reform and Consumer Protection Act § 911.

[10] *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).

[11] *See* Letter from Kenneth E. Bentsen, Jr., President & CEO, SIFMA, to Chairman Jay Clayton, SEC (Mar. 21, 2019); Letter from Michael C. Gitlin, et al., Partner, Capital Research and Mgmt. Co., to Honorable Walter Jay Clayton, Chairman, SEC (Feb. 11, 2019).

[12] We note that any new disclosure regime should be evaluated using the five factors set out by Chairman Clayton: materiality, comparability, flexibility, efficiency, legal liability, as well as weighing the both the costs and benefits of a new disclosure regime to managers, investors and providers.

higher commissions for Research.[13] We recognize, however, that although these appear to be simple concepts, their implementation raises complex issues, including with regard to what is included within the definition of "research" and how one measures whether investors are benefiting from the Research they help to pay for.[14]

Guiding Principles:

1. That the SEC use the impending expiration of the SIFMA No-Action Letter as an opportunity to strengthen the US capital markets ecosystem in relation to Research, with the goal of ensuring that the US capital markets retain their global leadership position. We encourage you to prioritize investor protection, investor choice (as it relates to Research payments), transparency, competitiveness, and cost (including both the costs to investors and the costs of compliance) as you work towards this goal;
2. That the SEC consider the interests of all investors in relation to Research, including, but not limited to, retail investors, asset owners, asset managers, and mutual fund managers; and
3. That the SEC consider the integrity of the securities marketplace by taking into consideration market participants of all sizes and geographies. It is important to consider the implications of any actions that could distort or favor one type of asset owner, manager, or Research provider over others, or one type or size of market participant over others.

Given the complex and multi-pronged nature of this work, we recognize that the Commission will require time to fully research and explore appropriate solutions. We acknowledge that these goals are not likely to be fully achievable by July 2020 when the SIFMA No-Action Letter expires. But inaction *IS* action and uncertainty creates disruption. Time is now very short and market participants need time to plan.[15] For these reasons, we urge you not to let the SIFMA No-Action Letter expire

[13] We note that Section 28(e) safe harbor already requires that a fiduciary have a basis to determine in good faith that any higher commission paid by the fiduciary's clients be reasonable in relation to the value of research obtained whether in relation to particular transactions or fiduciary's responsibilities to accounts for which the fiduciary has investment discretion. In order to be able to determine whether the costs paid for Research are reasonable, asset managers likely already have the information necessary to fulfill this duty. However, the fact that there is no requirement that investment managers provide any transparency related to those costs calls into question whether the current requirement is adequate to protect investors. See, e.g., Letter from Tyler Gellasch, Executive Director, Healthy Markets Association, to Jay Clayton, SEC (Apr. 2, 2018).

[14] For example, asset managers use many different tools to evaluate and make investment decisions, including without limitation, Research from brokerdealers and others, review of SEC public filings, earnings calls, calls with management, general news, pattern recognition, industry expertise, discussions with consultants, sophisticated trading strategies, the use of derivatives, tax analysis, legal analysis, etc. Sometimes an investment management decision is one not to invest at all, so the Research may have deterred an investment; sometimes it is a decision of *when* to buy or sell. Therefore, we recognize that it may be difficult for the SEC to establish a standard that would enable an investment manager to demonstrate a direct correlation between Research provided by third parties, investment management expertise, and investment returns.

[15] Some believe that the time may have already passed that would be necessary to enable (a) US broker-dealers to identify and take the business, legal and compliance actions that would be required to provide Research as Investment Advisers,

until you have completed your review and analysis, determined the best path forward, and given the global participants in the US capital markets impacted by these issues adequate time to adjust to your approach.

We are concerned that the broker-dealer, independent research, and investment management communities may not be able to design ways to operate consistently with both EU and US law, rules, business practices, and our guiding principles without regulatory relief. Regulatory inconsistency between the US and any other jurisdiction should not harm the participants in the US capital markets ecosystem, and regulatory action may be needed to prevent any such harm. For example, some have argued that, if the SIFMA No-Action Letter were to lapse in less than a year, the result could be a decline in the availability of Research more generally as some US broker-dealers shrink the size of their Research teams and cede business to non-US broker-dealers by default, both of which violate our first principle above. Others have expressed concern that, given a significant disparity in transparency for asset owners, US asset owners are exposed to the risk of paying too much for Research, cross-subsidizing costs of Research for their European counterparts, or paying for Research that does not benefit them.[16] But we also want to be clear that we are not only concerned about addressing these issues before the SIFMA No-Action Letter lapses; we also urge the SEC, , regardless of MiFID II, to more broadly (a) facilitate unbundling of Research for consumers regardless of geography and, (b) enhance transparency into the costs of Research.

Accordingly, we urge you extend the SIFMA No-Action Letter only as may be necessary to protect investors and the capital markets ecosystem. This includes providing market participants with time to adjust to your approach. [17]

Finally, it is our understanding that certain aspects of MiFID II may be under reconsideration in the EU (including those that impact the availability of research and trading liquidity). The implications of Brexit could also have an impact. Therefore, we urge you to use caution in basing any SEC action on the rules of a foreign jurisdiction that are both very new and still in flux. We applaud your efforts to prioritize the US capital markets and US investor protection and take comfort that you will be consistent in that approach as you devise a strategy for addressing these issues.

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or (b) the SEC to take formal rulemaking action or any other action within its authority that would fully touch on the business functions of the participants in the Research ecosystem impacted by MiFID II.

[16] Remarks of Amy McGarrity, Chief Investment Officer, Colorado PERA, before Meeting of the Securities and Exchange Commission Investor Advisory Committee, March 28, 2019.

[17] If the SIFMA No-Action Letter were to expire with no alternative arrangements or without sufficient time for broker-dealers and their clients to adjust, such inaction could have negative ramifications for US broker-dealers, asset managers with EU clients, and the US capital markets more broadly. US broker-dealers would no longer be able to provide Research services to EU clients (or asset managers with EU clients) without being regulated as Investment Advisers, which we believe some, if not many, would decide not to do. We are concerned that the inability of US broker-dealers to accept payments for Research from EU asset managers, and from US asset managers with EU clients, could disrupt the Research marketplace, reduce the information available to asset managers in making investment decisions (including in analyzing smaller issuers that already are subject to less coverage than larger issuers), and ultimately harm investors if the reduced access to Research resulted in lower returns.

We are ever grateful to the Staff of the SEC for their diligence, hard work, and dedication to the millions of investors in our US capital markets.

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