HEALTHY MARKETS
TRANSPARENCY & TRUST

December 21, 2018

Via Electronic Mail

Hon. Jay Clayton, Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20002

Re: Concerns Regarding Best Execution and Research Payments Issues

Dear Chairman Clayton,

We write to offer the Commission a path to address some of the concerns raised by the implementation of MiFID II.[1] New European rules, the Commission staff's response to them,[2] and pre-existing weaknesses in US rules have all combined to subject US investors to greater conflicts of interest, costs, and risks -- while also stifling competition and driving industry consolidation. Rather than simply accept these negative consequences, the Commission should adopt some modest reforms. Specifically, we urge the Commission to:

- rescind or revise the SIFMA No-Action Letter,[3]
- enhance best execution obligations for investment advisers,[4] and
- enhance disclosures regarding research and execution costs.

[1] Directive 2014/65/EU 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, O.J. (L 173) 57, 349, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0065.

[2] We have previously written you about our concerns with the Commission's role in shaping responses to MiFID II. *See, e.g.*, Letter from Tyler Gellasch, Healthy Markets Association, to Hon. Jay Clayton, SEC, April 2, 2018, *available at* https://www.sec.gov/comments/mifidii/cll5-3416684-162181.pdf. On October 26, 2017, the Commission staff issued three MiFID II-related no-action letters. Letter from Elizabeth Miller, SEC, to Steve Stone, SIFMA, Oct. 26, 2018, *available at* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm ("SIFMA No-Action Letter"); Letter from Aaron T. Gilbride, SEC, to Dorothy Donohue, Investment Company Institute, Oct. 26, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm; and Letter from Heather Seidel, SEC, to Timothy W. Cameron and Lindsey Weber Keljo, SIFMA AMG, Oct. 26, 2017, *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf. For the purposes of this letter, we will focus on MiFID II, but we think it is also worth noting that PRIIPS and similar best execution-focused rules are being adopted around the globe. At the same time, asset owners in the US and abroad are increasingly demanding enhanced transparency of costs and conflicts of interest.

[3] While other actions by the Commission may suffer from administrative defects, we do not take issue with the no action letters sent to SIFMA AMG or ICI.

[4] *See also*, Letter from Tyler Gellasch, Healthy Markets Association, to Brent J. Fields, SEC, Aug. 7, 2018, *available at* https://www.sec.gov/comments/s7-09-18/s70918-4182239-172535.pdf.

Background on US Investors' Concerns With Costs: Payments for Research and Trading

Investors in the United States have long been concerned with costs for research and trading services. For example, since March of 1998, the Council of Institutional Investors has had a policy to "support and urge full unbundling of pricing for investment management, brokerage and research services, so that institutional investors can purchase and budget for these services as they do any other expense of the plan."[5]

There's good reason for investors' desires for greater transparency in budgeting and paying for research. For example, one recent research report found that when fund managers pass the costs through to their customers, the costs may be significantly greater than if the fund managers paid directly out of their own accounts.[6] In that study, which examined 3,000 funds and 350 asset managers, advisers whose asset owners paid directly for research (through bundled commissions) paid 2.7 times more in North America than advisers who were paying with their own money.[7] As one consultant has observed, the "feeling is that funds passing on costs to clients are not being selective or disciplined enough with their research spend."[8]

The traditional bundling of research and execution costs has also rendered the pricing for each service remarkably opaque. Research providers often do not assign dollar values for the research they provide, and assigning specific values may be difficult for investment advisers -- particularly smaller advisers -- to perform.[9] This lack of price transparency, when combined with the fact that the costs have often been simply passed through to fund clients, has made it difficult for many investment advisers to engage in thoughtful determinations related to research consumption. As a result, research cost has not traditionally been as significant of a factor in the competition for research provision as it is now.

Competition for research based on quality and cost is a good thing for investors. Asset owners are increasingly focused on ensuring that their advisers are paying attention to their costs. Some asset owners are demanding that their investment advisers provide them with details of their research costs. Some are even entering commission recapture

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[5] Council of Institutional Investors, *Guiding Principles for Trading Practices, Commission Levels, Soft Dollars and Commission Recapture*, March 31, 1998, *available at* https://www.cii.org/policies_other_issues#principles_trading_commission_softdollar.

[6] Attracta Mooney, *Mifid II rules prompt 'huge change' in research marketplace*, Financial Times, Sept. 17, 2018, *available at* https://www.ft.com/content/6ff7f30e-ea59-3e57-bfee-1e136ede6c53.

[7] Id., (commenting on the implementation of research rules changes surrounding MiFID II).

[8] Id., (quoting Brian Quinlan, Quinlan & Associates).

[9] Notably, driven in part by customer demands and by MiFID II, many US investment advisers are attempting to determine dollar values for research consumed or engaging third-parties to assist them in this process. This process often reveals a spread between the volume and perceived "value" of research provided (as viewed from the provider's perspective) and the volume and value of the research consumed as viewed from the research consumer's perspective.

programs in attempts to mitigate their costs,[10] although these arrangements may create their own challenges for advisers and sub-advisers to obtain best execution. Put simply, asset owners are increasingly doing what they can to ensure their advisers are fulfilling their fiduciary obligations. But asset owners are also increasingly aware that their efforts to protect themselves may be insufficient.

One key contributor to investor concerns is the lack of regulatory framework for best execution for investment advisers. Historically, the Commission has offered almost no details regarding an investment adviser's best execution obligations, other than to (1) declare the adviser has a duty of best execution, and (2) flesh out some of the details regarding an exception to the best execution obligation--payments for research under Section 28(e).[11] Many investment advisers have appreciated the flexibility that has accompanied this ambiguity. That said, as the best execution landscape has evolved in recent years, this lack of specificity has created risks for advisers and asset owners.

While the Commission itself has offered no clarity, a recent OCIE Risk Alert has provided some outlines as to what would be viewed as likely violations of an adviser's best execution obligations.[12] Unfortunately, the OCIE Risk Alert still leaves many critical questions for investment advisers and their underlying asset owners unanswered. For example,

- While an adviser should perform best execution reviews, with what frequency must they be performed? Who should perform them?
- While an adviser should consider "materially relevant factors," what are they? And how should they be weighted?
- While an adviser should seek comparisons from other broker-dealers, what must that entail?

[10] *See, e.g., Commission Recapture Programs*, Government Finance Officers Association, Oct. 2010, *available at* http://www.gfoa.org/commission-recapture-programs.

[11] See, e.g., *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Sec. and Exch. Comm'n, Exch. Act Rel. No. 34- 23170, (Apr. 28, 1986), *available at*
https://www.sec.gov/rules/interp/34-23170.pdf.

[12] *Compliance Issues Related to Best Execution by Investment Advisers*, Sec. and Exch. Comm'n, at 2-4, July 11, 2018, *available at* https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf (2018 OCIE Risk Alert) (noting that a firm would be deficient if it doesn't:

- perform best execution reviews;
- consider "materially relevant factors" during their best execution reviews;
- seek comparisons from other broker-dealers;
- fully disclose their best execution practices;
- disclose its soft dollar arrangements;
- properly administer mixed allocations;
- have inadequate policies and procedures for best execution; or
- follow its best execution policies and procedures).

Further, there are also significant issues not addressed in the OCIE Risk Alert, such as whether certain soft dollar practices are still viewed as consistent with "best execution," including whether commissions generated by one fund may be used to pay for research that benefits exclusively another fund (with different investors).[13] Many investment advisers are still left questioning whether they are doing enough to ensure they meet their best execution obligations.

Unfortunately, the current applicable disclosure obligations are inadequate. The disclosures for many investment advisers -- even those with remarkably different practices -- are remarkably similar. It is not likely that even a very sophisticated asset owner would be able to differentiate between two different advisers, based on their disclosed "broker selection" or other best execution-related disclosures. Similarly, even disclosures that have been reviewed and updated since the advent of MiFID II do not appear to fully clarify for investors all the elements of how investment research may be identified, valued, allocated, and paid for. As a result, investment advisers with policies, procedures, and practices that may be more "customer friendly" are likely not directly rewarded for their approach. Customers simply can't tell them apart from other advisers with less "customer friendly" approaches.

In the absence of clear guidance, investment advisers may be retroactively viewed by the Commission, other regulators, or private parties as having failed to meet their obligations. At the same time, with few protections and almost no information about their true costs, asset owners are left exposed to significant risks of overpaying for research and trading.

Background on MiFID II Focus on Investor Costs: Payments for Research and Trading

Asset owners in Europe have also have long been concerned that their advisers have not been particularly judicious with their efforts to control costs for research and trading. After a lengthy investigation, seven years ago, the United Kingdom's Financial Services Authority (FSA) found that "some firms no longer saw conflicts of interest as a key source of potential detriment to their customers" and "had relaxed controls" below what it had felt were established market norms.[14] Worse, the FSA found "breaches of our detailed rules governing the use of customers' commissions and the fair allocation of trades between customers."[15] The regulator found "the majority of investment managers had inadequate controls and oversight when acquiring research goods and services from brokers or other third parties in return for client dealing commissions … [and] were

[13] This practice appears to be consistent with some longstanding interpretations of Section 28(e).
[14] Financial Services Authority, *Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks*, at 4, Nov. 2012, *available at* http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf.
[15] *Id*, at 4.

unable to demonstrate … how items of research met the exemption under our rules and were in the best interests of their customers."[16]

Put simply, the UK regulator found that asset managers were passing through the costs of research – including so-called "corporate access" – on to their customers without sufficiently scrutinizing and minimizing the costs to their customers.

In May 2014, the Financial Conduct Authority revised its rules to "ensure investment managers seek to control costs passed onto their customers with as much rigour as they pursue investment returns."[17] In July 2014, the FCA followed up the rules changes with a report on best execution and payment for order flow,[18] as well as a discussion paper on asset managers' use of commissions.[19]

In the meantime, on a parallel track, the European Commission adopted significant reforms in MiFID II. Under MiFID II, firms must take "all sufficient steps" to ensure best execution. This change raised the expectation from simply having a reasonable process, to having a process that actually achieves a specific result.

Additionally, MiFID II prohibits firms from routing orders based on inappropriate "inducements" (a.k.a. "payment for order flow" or "rebates") and explicitly requires advisers to pay for research using their own assets, specially dedicated Research Payment Accounts (RPA), or some combination of the two.

The new rules require firms to have detailed specifications for selecting brokers, routing orders, and paying for research. At a minimum, this requires explicitly knowing the dollar amounts for any research that might be paid by the adviser's underlying customers. Further, to improve analysis of firms' compliance with these standards, the new rules dramatically expand disclosure obligations.[20]

The SIFMA No-Action Letter Implements Policies That Are Contrary to Protecting Investors and the Public Interest

[16] Financial Conduct Authority, *Changes to the use of dealing commission rules: feedback to CP13/17 and final rules* (PS14/7), at 6, May 2014, *available at* https://www.fca.org.uk/publication/policy/ps14-07.pdf.

[17] Id.

[18] Financial Conduct Authority, *Best execution and payment for order flow* (TR14/13), July 2014, *available at* https://www.fca.org.uk/publications/thematic-reviews/tr14-13-best-execution-and-payment-order-flow.

[19] Financial Conduct Authority, *Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research* (DP14/3), July 2014, *available at* https://www.fca.org.uk/publication/discussion/dp14-03.pdf.

[20] For example, there are disclosure requirements for best execution policies, top brokers or venues with a firm may trade, and a firm's execution performance. There is also a set of required disclosures related to payments for costs -- including execution costs -- under the PRIIPS Costs and Charges framework.

While we are not supportive of simply importing the MiFID II and PRIIPS regimes into the US, we are strongly supportive of addressing the issues sought to be addressed by those regimes (reducing conflicts of interest and costs). In particular, we believe that investors deserve to know the research and trading costs that are paid from their funds. This transparency will dramatically improve their abilities to ensure that their advisers are fulfilling their fiduciary obligations.

At the time the Commission staff was considering its MiFID II-related no-action letters, there were several legitimate questions about whether and to what extent the European reforms may negatively impact smaller investment advisers, brokers, and research providers.

The SIFMA No-Action Letter did not insulate US market participants from the impacts of MiFID II, but did introduced significant unintended consequences. The SIFMA No-Action Letter, as relied upon by some brokers, establishes a regulatory policy that:

1. Forces some US asset owners to pay for research to that does not benefit them;
2. Subjects US asset owners to higher costs and puts US advisers at a competitive disadvantage;
3. Stifles competition amongst execution and research providers; and
4. Creates significant compliance and litigation risks for advisers.

None of these factors are addressed in the SIFMA No-Action Letter.

Since the SIFMA No-Action Letter was issued, US asset owners have been subsidizing foreign asset owners for research as the expense of US asset owners. Smaller, independent research providers in the US have been inhibited in their ability to compete with bulge bracket research providers. And highly specialized, smaller trade execution providers have been inhibited in their ability to effectively compete with firms who are compelling trading as the only mechanism through which they may be paid for research. And many smaller US asset managers have been squeezed to the brink of failure or consolidation.

The SIFMA No-Action Letter Results in US Asset Owners Being Compelled to Cross-Subsidize Non-US Asset Owners

Traditionally, in the US, research has been provided by the broker-dealer, used by the investment adviser, and paid by the asset owner. But while the costs are often borne by the asset owner, there is currently very little to protect them from overpaying for the research. At a very basic level, there is no requirement in the US that the research benefit the asset owner whose assets are being used to pay for it.

By contrast, under the now-implemented MiFID II regime, a covered fund's assets can be used to pay for research that is only explicitly disclosed to the asset owners and directly benefits that fund. Unfortunately, the interaction of these two disparate regimes is that an adviser with in-scope and out-of-scope accounts for MiFID II may pay for research using funds from out-of-scope customers (particularly US asset owners) to subsidize or outright pay for research for in-scope (e.g., European) customers. This is particularly likely for "corporate access," which isn't permitted "research" under MiFID II, but is in the United States.

Worse, the US asset owners have no reasonable way to identify the extent to which this may be occuring. There are no specific required disclosures for advisers to address this issue. The Commission's implicit approval of cross-subsidization for research costs across different investment advisory customers stands in sharp contrast to the Commission's longstanding concerns with inappropriate cross-trades,[21] trade allocations,[22] and other cost allocations.[23]

Unfortunately, the SIFMA No-Action Letter does not address any of these issues, much less describe how the policy it implements protects investors, promotes "fair and efficient" markets, or otherwise is in the public interest.

The SIFMA No-Action Letter Subjects US Asset Owners to Higher Research and Trading Costs and Disadvantages Some US Investment Advisers

The businesses of providing investment research and execution are increasingly specialized. The experience, resources, and ability to provide quality research are very different than those currently required for providing high-quality trade executions. Many investment advisers in the US and around the world separate the decisions regarding research from the decisions regarding trading.[24] Further, MiFID II and UK authorities have expressly confirmed this approach as essential to fulfilling best execution obligations. Unfortunately, one interpretation of the SIFMA No-Action Letter makes this impossible in the United States.

Currently, some large research providers in the US will accept cash payments for research while others will not. At least one of those firms has informed its adviser/customer that the SIFMA No-Action Letter is the reason why that firm will not

[21] *See, e.g., In the Matter of Putnam Investment Mgm't, LLC and Zachary Harrison*, SEC, Admin. Proc. File No. 3-18844, Sept. 28, 2018, *available at* https://www.sec.gov/litigation/admin/2018/ia-5050.pdf.

[22] *SEC v. Strategic Capital Mgm't, LLC*, No. 1:17-cv-10125 (D. Mass. filed Jan. 25, 2017), *complaint available at* https://www.sec.gov/litigation/complaints/2017/comp-pr2017-32.pdf (defendant subsequently pleaded guilty to a related criminal charge).

[23] *Risk Alert: Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers*, Office of Compliance, Inspections and Examinations, SEC, Apr. 12, 2018, *available at* https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf.

[24] Some view this as a key component of their best execution process.

accept a hard dollar check.[25] While some firms will accept checks pursuant to Commission Sharing Arrangements, others will not, or will discriminate between customers from whom they will accept CSA payments. But what happens when an adviser believes (based upon its own transaction cost analysis and other factors) that the research provider is not likely to provide the best overall price or execution quality? In these instances, advisers will have to choose between getting the research they need and the ability to shop for higher quality or lower cost executions. Put simply, they may be effectively compelled to trade with the suboptimal broker because it may be the only way the broker will accept payment for the essential research. This poses significant challenges to investment advisers seeking to fulfill their best execution obligations. Further, setting aside the issues with appropriately valuing the research and execution costs paid directly to the broker, this process may also lead to inflated execution costs for the investor.[26] Again, the costs come directly out of the fund without any clear or consistent disclosure to the underlying asset owners.

US investment advisers' inability to separately shop for research and executions also puts them at a competitive disadvantage to firms that have the ability to do that. For example, UK-based firms can simply trade with those who provide best execution, and then separately write checks to pay for research from whomever they desire. By contrast, US firms may be effectively forced to trade with firms that provide lower quality executions (e.g. higher trading costs), thereby reducing returns for their investors.[27]

The SIFMA No-Action Letter does not address any of these issues, much less explain how this protects investors, promotes "fair and efficient" markets, or otherwise is in the public interest.

The SIFMA No-Action Letter Stifles Competition Amongst Execution and Research Providers

The compelled bundling of research and executions stifles competition for execution quality. In particular, large banks often have the best "corporate access" and other important research services. Advisers, particularly those who rely more heavily on fundamental research and corporate access, may then be compelled to pay for it through trading.

At the same time, however, many advisers have transaction cost analysis and other reasons to believe that trading with those firms is likely to lead (or has led) to suboptimal trade executions. This directly inhibits competition for order flow based on best

[25] It baffles us as to why firms can take such disparate interpretations of the law. For that reason alone, it is clear that the Commission's prior interpretations and the SIFMA No-Action Letter should be revisited. Divergent interpretations of what the law mandates should not be a business competitive advantage.
[26] See generally, Financial Conduct Authority, *Changes to the use of dealing commission rules: feedback to CP13/17 and final rules* (PS14/7).
[27] While some firms may be able to pay through the use of Commission Sharing Arrangements or other similar arrangements, some research providers have proven unwilling to accept such payments from some investment advisers.

execution principles. Rather, it simply deprives firms that may provide higher quality executions (such as technology-driven trading firms) of the opportunity to compete for that order flow.

Similarly, what about a firm that has great research and no real execution framework? US advisers who may want that research are again in the awful position of deciding whether they can afford to pay out-of-pocket for that research, or alternatively shift the burdens to their customers (in a way that doesn't clearly show up as a disclosed fee or charge). And while this is not a new phenomenon, it is new that advisers are largely paying directly for research for their European customers. Thus, under the MiFID II regime, advisers may independently shop for research and execution, leading to more transparent research costs and lower trading costs. This allows for the proliferation of firms that may specialize in research or execution -- as opposed to simply promoting the aggregation of research and order flow into the same small handful of large brokers who provide both. For example, a recent research report by a leading independent broker-dealer, which was based on a survey of market participants, found that "46% [of buy-side respondents] think unbundling research has led to a change in how they source liquidity with 94% now having the freedom to select a more diverse range of execution providers."[28]

The SIFMA No Action Letter does not address these concerns, much less explain how this burden on competition -- which is exacerbated by the letter -- is appropriate or in the public interest.

The SIFMA No-Action Letter Subjects US Asset Managers to Significant Regulatory, Legal, and Compliance Risks

There are several key distinctions between the protections for US asset owners and asset owners that are "in-scope" for MiFID II. These discrepancies give rise to significant risks for compliance and litigation, not just by the Commission, but also by state regulators and private plaintiffs. In fact, there are several recent massive changes in disclosures that impact US firms operating abroad or with foreign investors, including:

- new disclosures of execution policies under Article 27 of MiFID II;
- reports pursuant to Regulatory Technical Standards 27 (which became effective in July 2018) and RTS 28 (which became effective in April 2018);
- PRIIPS Costs and Charges disclosures; and
- customers' demands.

But there are also very clear substantive differences between the US and European regimes for how research can be budgeted, to whom it may benefit, how it may be valued, and even what constitutes "research." In general, despite these massive differences, investment advisers around the world are increasingly:

[28] *Unbundling Research: Canary in the Coalmine*, Liquidnet, Nov 2018.

- Identifying and determining the explicit values of executions and research, separately;
- Paying for research in amounts that are not based on trading volumes (decoupling the amount paid for research from trading);
- Periodically evaluating trading decisions and adjusting routing decisions based upon increasingly sophisticated analyses;
- Creating and utilizing mechanisms to pay for research; and
- Dramatically revising their disclosures of best execution and order routing practices.

US-based investment advisers that have customers that are both in-scope and out-of-scope for MiFID II have taken a variety of approaches for attempting to reconcile their treatment of customers. Some have even gone so far as to take the incredibly burdensome (and costly) step of seeking to reimburse their customers for research costs: writing hundreds, or even thousands, of checks or transfers to alleviate direct research costs for their customers.[29] However, even this step does not alleviate the greater execution costs that may be associated with the bundled trades.

So what happens when a US asset owner learns that its returns are 7% per year, but that a foreign investor in the same strategy with that same adviser has a return of 7.25%? This type of preferential treatment of some investors over others is they type of discrimination that the Commission, state regulators (particularly those who may be acutely sensitive to pension funding), and private plaintiffs typically scrutinize. It is also simply unfair.

Unfortunately, that's the environment the SIFMA No-Action Letter has created. Again, the SIFMA No-Action Letter does not address any of these issues, much less explain how this protects investors, promotes "fair and efficient" markets, or otherwise is in the public interest.

The Process for Issuing the SIFMA No-Action Letter Was Inadequate

Before taking dramatic action, we would think that the Commission would need to (1) study MiFID II's impact on US markets and US market participants, (2) identify positive and negative impacts, (3) outline potential ways to address perceived concerns, and (4) analyze how its actions would address those concerns.

It did none of those things. The Commission never held any public hearings or discussion. The Commission never released any economic analysis of the issues and made no findings. The Commission did not detail its concerns or outline its potential options to address them. Nor did it engage in any cost-benefit analysis on the impacts of any of its potential actions. Instead, the Commission staff negotiated with selected

[29] *See, e.g.*, Sands Capital Management, LLC.

market participants and trade associations,[30] and then -- without the benefit of any public airing of issues or findings -- issued a sweeping, international directive that the agency characterized as a mere "no-action" letter just weeks before MiFID II went into effect.[31]

On its face, the SIFMA No-Action Letter is intended to relieve an entire class of firms from the legal obligation to register as investment advisers pursuant to the Investment Advisers Act of 1940.[32] The letter states that the staff

> would not recommend enforcement action to the SEC if a broker-dealer provides research services that constitute investment advice under section 202(a)(11) of the Advisers Act to a Manager that is required to pay for the research services by using Research Payments (a "Broker-Dealer").[33]

Notably, the SIFMA No-Action Letter purports to permit a broker to avoid registration even if the manager (customer of the broker) retains

> a non-EU domiciled investment manager who is

[30] Importantly, there appears to be no comprehensive public record of meetings, submissions, or findings related to the subject matter at issue in those letters. Rather, the SEC's press release announcing those letters has a "comments" link, which appears to include only subsequent communications with the Commission and staff. See *Comments on Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research*, SEC, *available at* https://www.sec.gov/comments/mifidii/mifidii.htm (last viewed Nov. 1, 2018). Nevertheless, in the press release announcing the decision, Chairman Clayton declared that "[t]oday's no-action relief was designed with input from a range of market participants to reduce confusion and operational difficulties that might arise in the transition to MiFID II's research provisions." Press Release, *SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions*, SEC, Oct. 26, 2017, *available at* https://www.sec.gov/news/press-release/2017-200-0. Worse, we question the accuracy of this "comment file," as it does not include, for example, several known meetings which involved representatives from Healthy Markets Association, Council of Institutional Investors, and individual firms.

[31] The letter requesting the SIFMA No-Action Letter was drafted just days before the SIFMA No-Action Letter itself was granted, and was only published by the agency at the time the staff granted the request. Letter from Steven W. Stone, Morgan Lewis, to Douglas J. Scheidt, SEC, Oct. 17, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a-incoming.pdf. Market participants, legal experts, and others who may have been able to assist the Commission staff in evaluating the request were effectively denied the opportunity to do so given that the letter was not published until after it was granted..

[32] We note that Commission officials have expressed some concerns over the breadth of the scope of the no-action relief provided. In particular, Commission officials have articulated a legal opinion that the Commission could not relieve all brokers who provide research of the obligation to register as investment advisers if they were to be compensated with a hard dollar check, but they could provide relief those brokers that are compelled to accept hard dollar checks under foreign law or a "contractual obligation" that has a similar requirement. We have no opinion on the merits of that claim, as it is irrelevant to our concerns.

[33] SIFMA No-Action Letter. If the "research services" were interpreted as constituting "investment advice under Section 202(a)(11)," the broker-dealer providing it would generally be compelled to register as an investment adviser under the Act.

> contractually required to comply with MiFID II or equivalent protections (*e.g.*, setting research budgets, accounting for research inputs, and having systems and controls to ensure that the receipt of research does not give rise to certain conflicts of interest).[34]

While this language would appear to allow a non-MiFID II covered investment adviser to contractually obligate itself to "equivalent protections," and thus relieve its broker of the obligation to register as an investment adviser if the broker were to receive a hard dollar check from that adviser, we have been informed by both SIFMA legal counsel and Commission staff that this interpretation is not intended. In fact, in a recent meeting with Commission staff, we were informed -- for the first time -- that the intended purpose of the language was to permit brokers to rely on the SIFMA No Action Letter in the circumstance that (1) the UK was not included in the MiFID II framework, and (2) the UK imposed similar requirements.[35] Nothing in the language itself appears to be so limited. None of this supposed intent appears in the public record of the Commission. And we are aware of no public analysis related to it.

The SIFMA No-Action Letter is not directed to any particular firm. Nor is it directed to any detailed set of facts that would be unique to a particular firm. Rather, it is directed to a trade association, and includes a hypothetical scenario with only a handful of relevant facts.

According to the accompanying press release,[36] the purpose of the Commission staff's letters was to "facilitate compliance with the new MiFID II research provisions while respecting the existing U.S. regulatory structure."[37] We understand that the Commission's primary purpose for granting the SIFMA No-Action Letter was to mitigate any impact on the provision of investment research so as to not negatively impact investment.[38] We assume that the desire to mitigate the impact of MiFID II on the provision of investment research relates to the well-publicized declines in payments for research that have accompanied the run-up and implementation of MiFID II in Europe.

Had the Commission engaged in any analysis of the issues, the Commission would have found that declines in the amounts paid for research does not necessarily mean a reduction in the amount of quality research consumed. In fact, one of the primary objectives for the MiFID II provisions was to "ensure investment managers seek to control costs passed onto their customers with as much rigour as they pursue

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[34] SIFMA No-Action Letter, n.2.
[35] Healthy Markets, Council of Institutional Investors, et. al meeting with Commission staff, Oct. 2, 2018.
[36] Press Release, *SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions*, SEC, Oct. 26, 2017, *available at* https://www.sec.gov/news/press-release/2017-200-0.
[37] Id.
[38] *See, e.g.*, Remarks of Hon. Jay Clayton, SEC, Before the SEC Investor Advisory Committee (Dec. 13, 2018).

investment returns."[39] The stated goal was to cut inflated research and execution costs that have accompanied the "bundled" commission payment model and stifled competition for research and execution.[40]

For example, neither the Commission nor staff has offered any economic analysis related to the impact of MiFID II on the provision for research or on its costs. The Commission and staff did not publicly consider how the letter would impact types of research coverage, quality of coverage, diversity of coverage, diversity of research providers, or cost of research. Nor are we aware of any public analysis regarding who would pay for research or its impact on them. Neither the Commission nor the staff have offered any public consideration of the impact of the SIFMA No-Action Letter on asset owners' or investment advisers' costs or conflicts of interest. There is no public exploration of the SIFMA No-Action Letter's impact on competition between investment advisers. The agency has not publicly considered how the SIFMA No-Action Letter could shift (and since has shifted) research costs to US investors in non-transparent ways. The record does not include any consideration of how the SIFMA No-Action Letter would impact investment advisers' ability to fulfill their best execution obligations consistently (particularly those with in-scope and out-of-scope for MiFID II customers). Finally, neither the Commission nor staff offered any public analysis of how these changes could ultimately impact investment.

Of course, the economics of the bundled research model currently favor the handful of largest "bulge bracket" research providers who can offer both research and trading services for their customers. Firms that may compel bundling enjoy excess economic rents, that may include inflated order flow volume and commissions. Investors must not only pay the research costs, but they may also absorb the costs of likely inferior execution quality. It is likely that the handful of large broker-dealer research providers who benefit the most from the current system may be net losers in a regulatory regime that permits competition and investor choice for both research and executions. But that does not mean that there will be less quality research consumed or less competition for research, much less lower investment. Notably, to date, while overall research spending has decreased significantly in Europe, most investment advisers in Europe have reported that they are still utilizing roughly the same number of research providers as prior to the implementation of MiFID II.[41]

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[39] Financial Conduct Authority, *Changes to the use of dealing commission rules: feedback to CP13/17 and final rules* (PS14/7), at 6, May 2014, *available at* https://www.fca.org.uk/publication/policy/ps14-07.pdf.

[40] Id., ("We want to ensure investment managers seek to control costs passed onto their customers with as much rigour as they pursue investment returns. … We found the majority of investment managers had inadequate controls and oversight when acquiring research goods and services from brokers or other third parties in return for client dealing commissions.").

[41] Greenwich Associates, *2018 European Equity Investor Study*, (2018) (finding European advisers reporting an average of approximately 15.7 research providers, statistically unchanged from 16.1 before the implementation of MiFID II).

At the same time, there appears to be strong evidence that MiFID II is not negatively impacting the provision of research for small and mid-cap stocks. For example, one recent survey of market participants found that "43% of sell-side have not altered their coverage of small & mid-caps and 57% plan to increase coverage."[42] Further, while research spending may be generally declining across the industry, we are aware of no studies suggesting that investors are struggling to obtain research they desire. Put simply, your concern that "the availability of research … is going to shrink"[43] should be allayed by the facts.

As far as process goes, the SIFMA No-Action Letter is effectively a rule change, but done through the guise of "no-action relief." Federal agencies are required to publish a "notice of proposed rulemaking" and "give interested persons an opportunity to participate in the rulemaking through submission of written data, views, or arguments."[44] As the Commission is all-too-well aware,[45] courts will strike down any rule that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law," is "in excess of statutory jurisdiction, authority, or limitations, or short of statutory right," or that was adopted "without observance of procedure required by law."[46]

Over the past few years, the Trump Administration and regulators have worked to reduce regulatory reliance on government interpretations in opinion letters, policy statements, agency manuals, and other guidelines, which generally "lack the force of law."[47] In fact, in part to address the overuse of agency actions outside of the formal rulemaking process, the Treasury department -- just days before the SIFMA No-Action Letter was issued -- recommended that the "SEC take steps to ensure that guidance is not being used excessively or unjustifiably to make substantive changes to rules without going through the notice and comment process."[48] Even more recently, Chairman Clayton declared

> Staff of the SEC frequently make their views known through a variety of communications, including written statements, compliance guides, letters, speeches, responses to frequently asked questions and responses to specific requests for assistance. The staff often addresses specific

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[42] *Unbundling Research: Canary in the Coalmine*, Liquidnet, Nov 2018.
[43] Remarks of Hon. Jay Clayton, SEC, Before the SEC Investor Advisory Committee (Dec. 13, 2018).
[44] Administrative Procedures Act, 5 U.S.C. § 553(b), (c).
[45] See *Bus. Roundtable v. SEC*, 647 F.3d 1144, (D.C. Cir. 2011); *see also*, *American Equity Investment Life Insurance Company v. SEC*, 613 F.3d 166, 167–68 (D.C.Cir.2010); *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C.Cir.2005). See also SEC Office of Inspector General, *Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings*, Report No. 499 (Jan. 27, 2012) ("OIG Report No. 499").
[46] 5 U.S.C. § 706(2).
[47] *Christensen v. Harris County*, 529 U.S. 576, 587 (2000).
[48] U.S. Dep't of the Treasury, *A Financial System That Creates Economic Opportunities: Capital Markets*, at 219 (Oct. 2017), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

> questions from particular SEC-regulated institutions or other stakeholders about Commission rules or regulations and how those rules or regulations may apply to a particular entity's specific facts and circumstances.
>
> The Commission's longstanding position is that all staff statements are nonbinding and create no enforceable legal rights or obligations of the Commission or other parties.[49]

The Commission's Director of Investment Management has recently echoed those remarks.[50] Nevertheless, the SIFMA No-Action Letter appears to effectively change the application of the law to a broad swath of market participants, without any public process, findings of fact, or reasoned analysis. It is unlikely that any court would conclude that "the agency has 'examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a rational connection between the facts found and the choices made.'"[51] While it is unclear whether the issuance of the SIFMA No-Action Letter would be reviewed under the framework of *Chevron*,[52] the letter is nevertheless unlikely to withstand significant judicial scrutiny.[53]

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[49] Hon. Jay Clayton, *Statement Regarding SEC Staff Views*, Sept. 13, 2018, *available at* https://www.sec.gov/news/public-statement/statement-clayton-091318. Notably, it was also announced that the "Division of Investment Management [had been asked to] continue to review whether prior staff statements and staff documents should be modified, rescinded or supplemented in light of market or other developments." Id.

[50] Dalia Blass, *Remarks before the ICI Securities Law Developments Conference*, Oct. 25, 2018, *available at* https://www.sec.gov/news/speech/speech-blass-102518 ("Statements of the staff are not statements of the Commission, and they do not have the force of law. … Our next steps are to continue our review and assessment of prior staff statements. In practice, that means our Chief Counsel's office and our disclosure office are looking at staff statements, including letters and frequent comments, and thinking about whether we need to make any changes. To me, this is just good government – as with all the staff's work on modernizing our regulatory framework, we should never hesitate to look back as well as ahead.").

[51] *Bus. Roundtable v. SEC*, 647 F.3d 1144, (D.C. Cir. 2011) (citing *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)).

[52] According to one analysis, the DC Circuit "applied the Chevron framework to informal interpretations 80.7% of the time" from 2003-2013. Kent H. Barnett and Christopher J. Walker, *Chevron in the Circuit Courts*, 116 Mich. L. Rev. 1, 46 (2017), *available at* https://digitalcommons.law.uga.edu/cgi/viewcontent.cgi?referer=https://scholar.google.com/&httpsredir=1&article=2144&context=fac_artchop.

[53] We note that Healthy Markets Association would have standing to bring suit to challenge the SIFMA No-Action Letter because at least one of our members would have legal standing, the interests we seek to protect are germane to our overall purpose, and neither the claim asserted nor the relief requested would require an individual member to participate in the suit. *Theodore Roosevelt Conservation Partnership v. Salazar*, 616 F.3d 497, 507 (D.C. Cir. 2010).

Commission Should Take Action to Address Investor Costs Related to Research and Trading

We urge the Commission to commit to protecting investors from unnecessary conflicts of interest, risks, and costs related to research and trading. At the same time, we disagree with the approach taken in MiFID II. We further do not believe that the Commission should compel investment advisers to bear the direct costs for research. Instead, we offer another path forward.

We recommend the Commission: (1) rescind the SIFMA No-Action Letter or interpret the "equivalent protections" language in a manner that is consistent with the plain meaning of the words,[54] (2) more clearly articulate expected best execution-related practices, and potentially offer investment advisers a rebuttable presumption of compliance with best execution obligations, if that standard is met, and (3) enhance advisers' disclosures of research and trading costs that may be passed on to their customers.

The "best execution" standard should provide that the adviser:

- has established and maintains a best execution committee that meets on at least a quarterly basis;
- measures and reviews (on a not less than quarterly basis) execution quality, based on a minimum list of "materially relevant factors";
- regularly evaluates broker performance and selection utilizing a minimum list of factors;
- makes active decisions regarding order routing and execution based upon its reviews;
- has appropriate policies and procedures, and practices related to the payment for research, including that it:
  - identifies and determines the value of research received and utilized;[55]
  - establishes research payment mechanisms that can comply with its Section 28(e) obligations;
  - establishes research payment mechanisms that decouple the amount paid for research from trading volumes;

[54] The "or equivalent protections" permission is already a contractual obligation between investment advisers and their customers. Accordingly, the Commission could simply publicly clarify that the letter's plain language means what it says: any asset owner and adviser may contractually obligate themselves to "equivalent protections," and so relieve the broker/research provider of the requirement to register as an adviser if it were to take a hard dollar payment from an adviser that represents to it that it is so-committed.

[55] The valuation of research has historically been a difficult and opaque process, and research providers have often been unwilling to assign any reasonable dollar value to the research provided. Similarly, research providers often provide investors with high volumes of low-quality, or unused research. Industry practices regarding the processes for valuing research are evolving rapidly, and we encourage the Commission to be, as an initial matter, not too proscriptive, and instead permit a variety of reasonable valuation approaches.

    - establishes research cost allocation mechanisms that ensure that customers who pay for the research directly benefit from that research (so as to constrict cross-subsidization);
- periodically reviews (on a not less than annual basis) best execution policies, procedures, and practices, as well as disclosures related thereto; and
- discloses its best execution policies, procedures, and practices, including all relevant conflicts of interest, soft dollar arrangements, etc.

Lastly, we urge the Commission to adopt a rule pursuant to Section 206 of the Advisers Act to ensure that advisers' disclosures accurately reflect the specific costs for research and trading that are passed through to customers.

Conclusion

Business practices, rules, and investor expectations around the world are changing. Simply attempting to insulate US market participants from the impacts of some foreign rules changes is not the answer, nor is simply accepting the negative impacts. The Commission should forge ahead with its own approach to protect investors and the public interest. Thank you for your consideration.

Sincerely,

Tyler Gellasch
Executive Director