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March 19, 2019

The Honorable Walter Jay Clayton
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: Comments on the Impact of MiFID II Research Provisions

Dear Chairman Clayton,

We appreciate the recent request by the United States Securities and Exchange Commission's staff (the "Staff") for additional public comment on the current research services landscape and, in particular, the opportunity to comment on possible next steps with respect to Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU ("MiFID II") relief.[1] The Staff's request follows the SEC's Division of Investment Management's issuance of temporary relief to allow U.S. registered broker-dealers to receive "hard dollars" (i.e. cash fees or payments) for research from money managers who certify that they are subject to MiFID II.[2] This temporary relief expires on July 3, 2020. The Staff's invitation arrives none too soon.

For the reasons explained below, we urge the Staff to allow broker-dealers to "unbundle" the cost of research and the cost of execution for all clients, not just for clients subject to MiFID II, as it has done to date. The Staff should clarify that a broker-dealer accepting hard dollars for research does not constitute "special compensation" that disqualifies a broker-dealer from the exception to the definition of "investment adviser" under Section 202(a)(11)(C) of the Investment Advisers Act of 1940 (the "Advisers Act").

[1] This letter is submitted by James Brigagliano and W. Hardy Callcott, both of whom are partners at Sidley Austin LLP. Mr. Brigagliano was former Deputy Director of the SEC Division of Trading and Markets; Mr. Callcott was former Assistant General Counsel for Market Regulation in the SEC Office of General Counsel. Both Mr. Brigagliano and Mr. Callcott regularly counsel clients on issues relating to the SEC and FINRA research rules. This letter is submitted solely in our personal capacities, not on behalf of any client or of the firm Sidley Austin LLP.
[2] *See* Securities Industry and Financial Markets Association, SEC Staff No-Action Letter, October 26, 2017, ("SIFMA No-Action Response") *available at* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm.

Background

MiFID II requires European Union ("EU") investment managers to unbundle research and execution costs, and will continue to impose this requirement for the foreseeable future. The SIFMA No-Action Response applies to EU managers that are directly subject to MiFID II (because such EU managers are authorized (registered) under the MiFID II framework), as well as to managers not directly subject to MiFID II but which are contractually subject to MiFID II (for example because they sub-advise EU MiFID II managers). The SIFMA No-Action Response applies at the manager level, including to U.S. funds or clients managed by a manager, because generally it is impossible to distinguish between research obtained for the benefit of an EU client and research obtained for the benefit of a U.S. client of the same manager. As a result, a substantial number of U.S. managers have taken advantage of the SIFMA No-Action Response, and will continue to need that relief on an ongoing basis.

The fact that a large number of EU and U.S. managers are using the relief provided in the SIFMA No-Action Response has led to many U.S.-only counterparts joining the chorus seeking the ability to unbundle, though they are not legally compelled to do so.[3] These managers are evidently seeking transparency in execution and research pricing under the assumption that such transparency may promote best execution. Notably, many state and local government pension plans have requested the ability to unbundle research and execution costs.[4] Some firms are using innovative ways to reach the same result. For example, published reports indicate that two of the largest U.S. investment managers, Capital Group and T. Rowe Price, are continuing to pay for research out of Commission Sharing Arrangements ("CSAs") funded by "soft dollars" (i.e. benefits other than cash payments), so they know exactly how much the research costs, as permitted by an existing SEC no-action letter.[5] However, money managers are then refunding the funds the costs of that research.[6] Of course, if an asset manager is reimbursing the funds for

[3] Siobhan Riding, *Invesco and Wellington Eye Global Adoption of Mifid II*, FINANCIAL TIMES, March 4, 2019, *available at* https://www.ft.com/content/075382ef-6c58-3b21-9010-63aa8e013d70.

[4] *See, e.g.*, Letter from Amy C. McGarrity, Chief Investment Officer, Colorado Public Employees' Retirement Association ("PERA"), to Hon. Clayton, January 31, 2019, *available at* https://www.sec.gov/comments/mifidii/cll5-4919382-178351.pdf (requesting on behalf of PERA, an asset owner responsible for retirement and other benefits to more than 600,000 Colorado public employees, the unbundling of research services from execution); Letter from David Villa, Executive Director/Chief Investment Officer, State of Wisconsin Investment Board ("SWIB"), to Hon. Clayton, January 31, 2019, *available at* https://www.sec.gov/comments/mifidii/cll5-4864096-177346.pdf (requesting on behalf of SWIB, a public pension responsible for managing the Wisconsin Retirement System, the SEC allow soft dollar and hard dollar payments to broker-dealers).

[5] *See, e.g.*, John D'Antona, *WBR ELS: T Rowe's Williams Talks SEC and MiFID II*, MARKETS MEDIA, December 6, 2018, *available at* (https://www.marketsmedia.com/wbr-els-t-rowes-williams-talks-sec-and-mifid-ii/); Beagan Volz, *Cap Group Stops Charging Investors for Third-Party Research*, IGNITES, January 3, 2019, *available at* (http://ignites.com/c/2168123/260583/group_stops_charging_investors_third_party_research?referrer_module=article&module_order=0).

[6] Volz, *Cap Group Stops Charging Investors for Third-Party Research*, IGNITES, January 3, 2019, *available at* (http://ignites.com/c/2168123/260583/group_stops_charging_investors_third_party_research?referrer_module=article&module_order=0); *Wall Street braces for MiFID-style rules descending on U.S.*, PENSIONS & INVESTMENTS, January 24, 2019, *available at* (https://www.pionline.com/article/20190124/ONLINE/190129924/wall-street-braces-for-mifid-style-rules-descending-on-us).

research purchased from broker-dealers, from an economic standpoint it is exactly the same as having the money manager pay broker-dealers for the research directly.

These developments raise the question whether the Commission should take the position that paying with hard dollars triggers a different regulatory result by requiring the research provider to register as an investment adviser versus allowing payments from CSAs and-then-reimbursement by the manager, which is permissible for a broker-dealer. In our view, unbundling is here and here to stay. The Commission must now determine whether unbundled research is required to be provided by investment advisers or whether broker-dealers may continue to leverage their insights and provide the research services that their clients request. As discussed below, the SEC and FINRA carefully constructed the regulatory response to the research analyst conflict of interest scandal in the early 2000s. To build that regulatory structure, FINRA issued Rules 2241 and 2242, required research analysts to register, and required analysts and their supervisors to pass the Series 16, 86 and 87 qualification examinations. Furthermore, the SEC adopted Regulation Analyst Certification ("Regulation AC"). That entire framework would become completely ineffective if the research function was pushed into investment advisers, because those rules are all premised on securities research being offered by broker-dealers, not by firms solely registered as investment advisers.

The legal issue arises here based on the application of Section 202(a)(11)(C) of the Advisers Act. That provision generally excludes from the investment adviser definition "any broker or dealer that provides investment advice to clients but whose performance of such services is solely incidental to the conduct of its business as a broker or dealer and which receives no special compensation therefor." When broker-dealers provide research through soft dollar arrangements, there has been little question that the research is "incidental" to their brokerage business. Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act") explicitly contemplates that broker-dealers will offer research to clients. If however, payments for research and execution of trades are unbundled, then questions may arise about the nexus between the research and the trades. In other contexts, the Commission already has expressed support for the ability of managers to direct research dollars independently of execution. For example, the SEC's 2006 Release regarding soft dollar practices endorses commission sharing arrangements that allow money managers to direct soft dollars earned at one broker-dealer to pay for research at another.[7] Several related no-action letters ("NALs") further apply and extend that principle.[8] Finally, in the SIFMA No-Action Response, the Staff has endorsed unbundling in the context of managers subject to MiFID II. Thus, to a fair degree, the Commission and its Staff have already endorsed the unbundling of research from execution, and for good reason.

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[7] *See* Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54165, July 18, 2006, *available at* https://www.sec.gov/rules/interp/2006/34-54165.pdf.

[8] *See, e.g.*, Investment Company Institute, SEC Staff No-Action Letter, October 20, 2017, ("ICI No-Action Response"), *available at* https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm; SIFMA No-Action Response, *supra* note 1; BNY Converge-Ex, LLC, SEC Staff No-Action Letter, September 10, 2010, ("BNY Converge-Ex No-Action Response"), *available at* https://www.sec.gov/divisions/investment/noaction/2010/bnyconvergex092110.pdf.

There are strong policy arguments to allow registered broker-dealers to accept hard dollars from U.S. money managers irrespective of MiFID II. These arguments include promoting best execution through pricing transparency and encouraging independent research by allowing broker-dealers with research strengths in particular sectors to market their expertise to money managers independent of trading relationships. Moreover, research issued by broker-dealers in the U.S. is among the most heavily regulated broker-dealer activities given FINRA's comprehensive rule structure, the SEC's regulations, and the policies and practices of the largest U.S. firms after the Global Research Analyst Settlement in 2003. After spending years following the directive of the Sarbanes-Oxley Act to design a comprehensive scheme to manage, mitigate, and disclose conflicts that could undermine the independence of research, to require broker-dealers to move research into an investment adviser structure, in order to accept hard dollars, would sacrifice sound policy years in the development at the altar of definitional fealty. Moreover, moving research to investment advisers would actually weaken investor protection, because advice offered by a stand-alone investment adviser will not be subject to FINRA rules relating to research.

The SEC Interprets Section 28(e) to Permit Money Managers to Allocate Commission Credits to Research Providers Without Regard to Whether those Providers Executed Trades

Traditionally, money managers in the U.S. have received research as part of their commission arrangements with broker-dealers. Section 28(e) of the Exchange Act provides a safe harbor that protects money managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate in order to receive "brokerage and research services" provided by a broker-dealer, if the managers determine in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services. Section 28(e) requires that the broker-dealer receiving commissions for "effecting" transactions must "provide" the brokerage or research services. Research is defined very broadly under Section 28(e). Under Section 28(e)(3)(A), a person provides brokerage and research services if he or she "furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities."

For purposes of Section 28(e), the following attributes help determine whether the broker-dealer that is effecting transactions for the advised accounts has satisfied the "provided by" element, and the Section 28(e) safe harbor is available to a money manager:

(i) the broker-dealer pays the research preparer directly;

(ii) the broker-dealer reviews the description of the services to be paid for with client commissions under the safe harbor for red flags that indicate the services are not within Section 28(e) and agrees with the money manager to use client commissions only to pay for those items that reasonably fall within the safe harbor; and

(iii) the broker-dealer develops and maintains procedures so that research payments are documented and paid for promptly.

The SEC Interpretive Release on Soft Dollars

In July 2006, the SEC issued interpretive guidance on money managers' use of client commissions to pay for brokerage and research services under the Section 28(e) "soft dollar" safe harbor of the Exchange Act. The Commission interpreted the safe harbor provided by Section 28(e) to apply to money managers who use client commissions to pay for research produced by someone other than the executing broker-dealer, in certain circumstances (referred to as "third party research"). The SEC stated in the 2006 release *"[w]e recognize the benefit to investors of money managers being able to functionally separate trade execution from access to valuable research"* (emphasis added). The Commission also has clarified that research provided in third party arrangements is eligible under Section 28(e) even if the money manager participates in selecting the research services or products that the broker-dealer will provide. In addition, the Commission has stated that the third party also may send the research directly to the broker-dealer's customer. To come within the Section 28(e) safe harbor, the credits must be accrued with a broker-dealer who had some role in effecting a particular trade. There is no difference in using commissions to acquire proprietary sell-side research or to acquire independent research, data or analytical tools.

In this guidance, the SEC not only clarified its stance on what could qualify for this "soft dollar safe harbor", but the Commission also accepted the use of Client Commission Arrangements ("CCAs"), also known as CSAs, to pay for research services. A money manager may use its credits to purchase research, which would include trader commentary, at a third party broker-dealer which may not have effected the transactions that gave rise to the soft dollar credits. The means by which a money manager can select third party research includes the process by which a money manager may accrue soft dollar credits in a CCA or CSA and subsequently direct those dollars to be paid to designated research providers. Beginning in the UK, CSAs were popularized as the structure of choice. Money managers could trade with whomever they liked, and then direct a portion of the commissions generated with the executing CSA brokers to a single account, from which the money managers pay for the research of third party brokers and independent research providers. In addition, the Commission has stated that a third party also may send the research directly to a broker-dealer's customer. In adopting that posture, the Commission sought to encourage independence in research by allowing money managers the flexibility to execute with one broker-dealer and obtain research from another.

SEC Staff Guidance Indicates that CCAs are Well-Established

The SEC has been aware of CCAs and similar arrangements for at least ten years, and has addressed them in several NALs. Subsequent to the SEC's July 2006 guidance on soft dollars, the SEC's Division of Trading and Markets issued a NAL on January 17, 2007 to Goldman Sachs & Co. ("GS&Co.") ("Research XPRESS") which confirmed that research firms that are not broker-dealers may be compensated for providing research services to their money manager clients through payments from a "commission pool" set apart in a client commission arrangement under Section 28(e) without registering as broker-dealers. The Research XPRESS NAL allows money managers to direct commissions generated from transactions executed through GS&Co. to research service providers without those entities registering as broker-dealers in compliance with

Section 28(e). We recognize that the Research XPRESS NAL does not expressly address whether the service providers are required to register as investment advisers, but the Commission staff did not require a representation that they were so registered.

Then, on September 10, 2010, the SEC's Division of Investment Management (the "Division") issued the BNY ConvergEx Group, LLC, a research broker-dealer, a NAL concerning CCAs.[9] The Division noted that some money managers either hard dollars and other soft dollars accumulated in a CCA to pay for research from broker-dealers. The Division observed that some research broker-dealers were reluctant to accept payments from a CCA for fear of being deemed an investment adviser, and thus the broker-dealer could not conduct any principal trades with the accounts managed on a discretionary basis (the "Managed Accounts") under Section 206(3) of the Advisers Act. The Division concluded that accepting payments from a CCA would not create an investment adviser/client relationship between the research broker-dealer and the Managed Accounts. Notably, the Division stated that its position applied whether or not the research services were provided under the Section 28(e) safe harbor.

We are aware that the SEC has seen, at least to some extent, actual hard dollar payments from investment managers to broker-dealers for research for more than ten years. In 2006, for example, *Barron's* reported that one of the largest U.S. asset managers announced that it had agreed to pay two U.S. broker-dealers hard dollars for research.[10] In that case, it was reported that the research payments would be from the adviser and the trading costs were to remain allocated to the fund. To our knowledge, the Staff has never questioned whether those activities trigger investment adviser status. It should not do so now.

MiFID II

On January 3, 2018, the European Market Infrastructure Regulation ("EMIR") MiFID II rules became effective. That regime requires money managers to "unbundle" payments for execution from associated "inducements" which include research and possibly trader commentary. Under Articles 24(7)(b) and 24(8) of the MiFID II Directive, EU investment firms providing portfolio management, or investment advice on an independent basis, are not permitted to accept fees, commissions or any monetary or non-monetary benefits from third parties in relation to the provision of services to clients. The rationale for the directive is that such fees or benefits would be inducements and thus create conflicts of interest between a firm and its clients. The European Securities and Markets Authority ("ESMA") required that, in order for investment research not to constitute an inducement, the investment firm must pay for the research directly with its own funds, or pay for such research from a designated research payment account funded by specific charges to its clients. That is, investment firms could no longer pass on broker commissions to their clients where such commissions encapsulated execution fees as well as research costs. In enacting MiFID II, the EU is seeking to promote transparency in order to facilitate best execution.

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[9] BNY Converge-Ex, No-Action Response, *supra* note 7.

[10] *See* Lawrence Strauss, *Fidelity's Firm Stand on Soft Dollars*, BARRON'S, January 23, 2006, *available at* https://www.barrons.com/articles/SB113780055556352497.

Driven in large part by MiFID II, global money managers, and in some cases U.S. money managers, have begun requesting U.S. broker-dealers to be able to pay for research with hard dollars. That, in turn, has raised the issue whether U.S. broker-dealers can accept hard dollars for research without being deemed to have accepted "special compensation" for investment advice and therefore need to register as investment advisers. In SIFMA's No-Action Response Letter,[11] the Staff stated that for the first 30 months after the implementation of MiFID II (i.e., until July 3, 2020), a U.S. broker-dealer may accept payments from an investment manager required by MiFID II to pay for investment research, without being registered as an investment adviser.

The US research industry has relied on the SIFMA No-Action Response Letter in order to be able to comply with both MiFID II and the SEC and FINRA research rules. There is no indication that the EU will reconsider MiFID II, and thus the relief provided by the SIFMA No-Action Response Letter continues to be necessary. We are not aware of any problems or abuses that have arisen because of the SIFMA No-Action Response Letter, and thus we believe there is no policy or legal reason the SEC Staff should withdraw that relief. Were the SEC to consider withdrawing the SIFMA No-Action Response Letter, we believe the US research industry would need at least 18 months to restructure in response to that decision – which would be an expensive and unnecessary distraction from important ongoing compliance initiatives.

U.S. Money Managers are Requesting to Pay for Research with Hard Dollars

Numerous broker-dealers have reported an increase in U.S. money managers requesting that they be able to unbundle research from execution and pay for research with hard dollars. In some cases, the managers represent that they are subject to MiFID II because of a UK or other EU affiliate in their families or because they have a contractual obligation as a sub-adviser to an EU manager, but in some cases they are not able to make that representation. The U.S. managers are, of course, not following a regulatory mandate in this country, but are being responsive to what they believe to be their best execution obligations to their clients. Other U.S. managers, notably large state and local government pension funds, also are seeking to unbundle research from execution costs, but because they are not subject to MiFID II, broker-dealers are reluctant to take these payments. As a result, U.S. broker-dealers are placed in a quandary. They must reject the requests of their institutional clients and risk losing business or consider a significant restructuring of their businesses. They should not have to do either.

Requiring Restructuring of Research would be Costly and Could Diminish Investor Protection

Unless relief is provided, a broker-dealer would be forced to restructure in one of two ways. The broker-dealer either could set up a separate registered adviser affiliate or dually register. Either approach would involve dislocation. The former approach would be simpler to achieve and more popular. If research is required to be housed in an investment adviser, there would be no reason to assume the additional expense and complexity of broker-dealer regulation.[12] But this approach

[11] SIFMA No-Action Response, *supra* note 1.

[12] Moreover, setting up the research function in a separate legal entity likely would avoid difficult questions about the application of the principal trading restrictions of Section 206(3) that would otherwise exist if the research

would completely undermine the investor protections provided by the current regulatory scheme for securities research, all of which applies only to broker-dealers.

A firm could create a separate affiliate (the "Research Adviser") and register it as an investment adviser. The Research Adviser would prepare and file a Form ADV with the SEC. The Research Adviser would be staffed with research analysts and dedicated compliance personnel. The Research Adviser analysts would cover companies and issue research reports, notes, and other market commentary. While the Research Adviser likely would not undertake to provide individualized advice with respect to a client's individual positions or trades, its analysts would be available to speak with investors who pay for research; and these clients would be deemed clients of the Research Adviser.

Presumably, the Research Adviser would enter into a services agreement with an affiliated broker-dealer to provide research and consultation to the broker-dealer's investment banking and sales and trading staffs. Such assistance would likely include, for example, meeting with investment banking clients of the broker-dealer, participating in education of the sales force, and in non-deal roadshows. The Research Adviser would also assist in due diligence. The Research Adviser would need to be cognizant of potential broker-dealer agent registration issues with respect to employee activities that may require broker-dealer agent registration (*e.g.*, solicitation). The Research Adviser would receive hard dollar payments from money managers for its research services. In addition, it would receive a payment from the broker-dealer in an amount equal to the soft dollar credits directed to the broker-dealer or the Research Adviser. Also, the Research Adviser could receive soft dollar payments from clients who had CSA or CCA accounts at other broker-dealers.

Importantly, the Research Adviser, as an independent affiliate, would not be subject to the comprehensive regulation of FINRA's conflicts or registration rules or the SEC's Regulation AC. Nor would the Research Adviser be subject to FINRA's qualification examination requirements. In that scenario, a broker-dealer would not be required to supervise the Research Adviser. The broker-dealer could distribute its affiliate's research to its retail customers pursuant to FINRA Rule 2241(h). Moreover, the following Advisers Act provisions and related obligations regarding suitability, custody, wrap fee, best execution, aggregation of client orders, and principal trading and cross trades ***should not apply*** to the Research Adviser because it will not hold customer accounts, nor trade on behalf of customers or on a proprietary basis. Furthermore, there should not be any beneficial ownership required disclosures under Exchange Act Section 13(f) because the Research Adviser would not hold proprietary positions.

The Research Adviser would have to have to establish its own compliance program under Rule 206(4)-2, and its own Code of Ethics under Rule 204A-1. However, there would be no requirement that these documents mirror the substantive requirements of FINRA's research conflicts rules nor the SEC's Regulation AC. For institutional customers who wish to pay the

function were contained in a dually-registered firm that also received commissions for executing securities transactions resulting from the research. *See* Interpretation, Application of Section 206(3) of the Investment Advisers Act of 1940, Investment Adviser Act Release No. 1732, July 17, 1998, *available at* https://www.sec.gov/rules/interp/ia-1732.htm ("the 1998 Section 206(3) Interpretation").

Research Adviser directly and interact with individual analysts, the Research Adviser would have to deliver a Form ADV, but of course the disclosure requirements of the Form ADV are not designed for an investment adviser that does not manage or advise customer accounts.

FINRA's research rules and the SEC's Regulation AC would only apply if research analysts are dually-registered and remain associated persons of a broker-dealer. In addition, if a broker-dealer, also registered as an investment adviser, created advisory accounts within the broker-dealer that accept hard dollars for research then FINRA and SEC rules and regulations would apply. Furthermore, a broker-dealer would need to approve the activities performed on behalf of the Research Adviser as outside business activities, and would be required to supervise the dually-registered analysts' investment adviser activities, as if they were being conducted through the a broker-dealer under NASD Notices to Members 96-33 and 94-44.[13] In addition, any trading in the advisory accounts likely would be subject to principal trading and cross trade restrictions under the 1998 Section 206(3) Interpretation. Thus, to the extent that an investment adviser is viewed as providing personal advice, the broker-dealer would need to code the accounts so they could not trade as the principal without the consent of the broker-dealer. Institutional clients could utilize both brokerage and fee-based accounts. Clients could use a brokerage account to trade actively and a fee-based account through which to acquire research.

The dually-registered broker-dealer and investment adviser firm (the "New BD/IA") would have all of the regulatory requirements of a stand-alone registered investment adviser. Thus, the New BD/IA would register with the SEC as an investment adviser under the Advisers Act and depending on the current membership agreement may need to submit a continuing membership application to FINRA pursuant to NASD Rule 1017. Client relationships with the New BD/IA would need to be repapered. The New BD/IA would be subject to the books and records, advertising, and disclosure requirements under the Advisers Act. In regard to the New BD/IA's Form ADV disclosures, the New BD/IA would need to disclose, at the outset of the relationship, the firm's potential conflicts of interests, separate and apart from what FINRA's rules already require with respect to research reports. The Form ADV disclosure does not include issuer-by-issuer disclosures. Then, on a report-by-report basis, the broker-dealer would have to disclose all of the conflicts relevant to that report.

Based on the foregoing comparison of alternatives, to the extent that firms must restructure in a way to accept hard dollars, some may utilize dual registration and incur the burdens of that structure, but many will likely choose forming a separate registered investment adviser to issue research, thereby diminishing the overall investor protection that currently governs the research landscape. That cannot be the Commission's goal and should not be the unintended consequence.

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[13] As applied to individuals associated with both a broker-dealer and an investment adviser, FINRA has concluded that the requirements of the NASD Notices to Members cited in the text are so burdensome that it has proposed to withdraw them, although FINRA has not yet submitted this proposal to the SEC for approval. *See* FINRA Notice 18-08, February 26, 2018, *available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-08.pdf.

Harmony with Current Regulatory Scheme for Research Services

There are strong policy reasons why the Commission should not deem either hard or soft dollar payments for research to be special compensation. The SEC's Regulation AC, which requires that research analysts certify the truthfulness of their research, assumes a world in which research is produced primarily by broker-dealers. It applies to broker-dealers and certain of their associated persons. It does not apply to investment adviser affiliates of broker-dealers who meet the information barrier requirements of the rule. Moreover, the entire scheme of FINRA's research rules, which have been approved by the SEC, are directed at broker-dealers. We would emphasize the comprehensiveness of the current FINRA and SEC research rules and regulations for broker-dealers.

Following the Global Research Settlement, the Sarbanes-Oxley Act directed the SEC to adopt or oversee comprehensive self-regulatory organization (SRO) rules to address conflicts of interest which may compromise the integrity of research. At that time, the regulators considered requiring that investment research be conducted by a wholly separate affiliate. However, the ability of research to provide insights to broker-dealer customers, as well as all business lines of the firm, was deemed too valuable to sacrifice. Ultimately, the SEC, NYSE and NASD determined to preserve the positive synergies of integrated broker-dealers, but required internal compliance policies to prevent pressures that could compromise securities research.

The SRO research rules that were adopted after Sarbanes-Oxley focus on potential conflicts of interest stemming from broker-dealers' investment banking and sales and trading activities, as well as personal trading by the analyst. To that end, the rules require the structuring of business lines and supervisory authority to insulate analysts from pressures from investment banking and sales and trading. They also require explicit disclosures of commercial activities and business relationships that could have an impact or the perception of an impact on the independence and integrity of research. The rules have also been expanded to cover debt research. The rules also require broker-dealer research analysts and their supervisors to pass detailed licensing exams specifically tailored to the research business. FINRA, after SEC approval, has updated these research rules several times to address issues that have arisen since their initial adoption, and expanded the rules in 2016 to cover debt research in addition to equities research. Since 2016, FINRA has aggressively enforced the research rules bringing over 30 cases resulting in fines and additional sanctions in excess of $32 million dollars.[14] We note that the Commission's Office of Compliance Inspections and Examinations reported examining only 17% of SEC-registered investment advisers last year, and (because of the government shutdown) it is unlikely to reach even that rate in 2019.[15] By contrast, FINRA examines broker-

[14] The data comes from FINRA's *Monthly and Quarterly Disciplinary Actions*, *available at* http://www.finra.org/industry/disciplinary-actions. In 2016 FINRA reported at least 13 cases resulting in fines and sanctions of approximately $13.8 million, in 2017 at least 10 cases resulting in fines and sanctions of approximately $6 million, in 2018 at least 7 cases resulting in fines and sanctions of approximately $12.2 million, and as of February 2019 one case resulting in a fine of $50,000.

[15] U.S. Securities and Exchange Commission, 2019 Examination Priorities, Office of Compliance Inspections and Examinations, *available at* (https://www.sec.gov/files/OCIE%202019%20Priorities.pdf); Melanie Waddell, *Advisor Exam Rate Likely to Drop in 2019*, THINK ADVISOR, March 7, 2019, *available at*

dealers that provide research at least every two years, and larger research firms every year. Forcing research to move to investment advisers would put a greater strain on the Commission's limited examination resources.

Congress has repeatedly taken actions to facilitate **broker-dealer research**, including:

a. The exclusion of broker-dealers from the definition of "investment adviser" in Section 202(a)(11)(C);

b. The addition of Section 28(e) to the Exchange Act in 1975 following the elimination of fixed commissions to preserve the ability of investment managers to use client commissions to pay for research services;

c. The enactment of the Sarbanes-Oxley Act in 2002 to direct that the Securities and Exchange Commission implement a comprehensive regulatory scheme for broker-provided research services, including requiring the adoption of rules to address conflicts impacting securities analysts and research reports;

d. The enactment in 2012 of the Jumpstart Our Business Startups Act (the "JOBS Act") to, among other things, provide broker-dealers with greater flexibility in the publication of research reports on emerging growth companies around the time of IPOs in which they participate; and

e. The enactment of the Fair Access to Investment Research Act in 2017 to extend the current safe harbor available under Rule 139 of the Securities Act of 1933 to covered investment fund research reports.

If the SEC deemed payments for research to trigger investment adviser registration, so that firms had a regulatory incentive to move their research operations to investment adviser entities, we believe it would render the existing SEC-approved FINRA scheme of research regulation largely ineffective. Moreover, there is a long line of SEC guidance in the form of NALs that indicate investment advisers do not need to register as broker-dealers, even though, as a literal matter, virtually all investment advisers execute transactions for the accounts of others.[16] We believe the larger explanation for these NALs is the concept of an adequate alternative scheme of regulation. There is no justification for requiring investment advisers to register as broker-dealers when there is an adequate regulatory scheme for investment advisers. Similarly, here, there is no policy justification for superimposing regulations that pertain to investment advisers on top of, or replacing, the existing comprehensive broker-dealer regulatory structure and oversight over research services and analysts. Research coverage has already been diminished for smaller public

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(https://www.thinkadvisor.com/2019/03/07/advisor-exam-rate-likely-to-drop-in-19-due-to-shutdown-sec/?slreturn=20190218164545).

[16] *See, e.g.*, Federalist Management Corporation, SEC No-Action Letter (pub. avail. April 8, 1971); Invescap of Florida, Inc., SEC No-Action Letter (pub. avail. March 28, 1975; First Atlantic Investment Advisory Corp., SEC No-Action Letter (pub. avail. March 22, 1974); F.A. Spina & Co., SEC No-Action Letter, (pub. avail. March 5, 1983); Kirr, Marbach & Company, SEC No-Action Letter (pub. avail. February 6, 1977); and McGovern Advisory Group, Inc., SEC No-Action Letter (pub. avail. September 8, 1984) (collectively, the " Investment Adviser Letters").

companies over the past 15 years according to many sources because of regulatory burdens and other market developments.[17] The Commission should not create another expensive obstacle for firms to navigate – the likely result would be less research, and less liquidity, for smaller public companies and their shareholders.

The FPA Decision does not Preclude the Commission from Granting Relief

We do not believe that the D.C. Circuit's opinion in *Financial Planning Association v. SEC,* gives the SEC less latitude to deem hard dollars paid for research to be something other than special compensation.[18] In the rulemaking leading to the *Financial Planning Association* decision, the Commission conceded the fee-based payments to broker-dealers constituted special compensation, but the Commission argued that it could exempt brokers receiving special compensation from the Advisers Act under the "catch-all" exemptive provision of Section 202(a)(11)(H). The D.C. Circuit disagreed, and held that Commission's position was effectively an effort to rewrite the broker-dealer exception in Section 202(a)(11)(B) of the Act by entirely eliminating the special compensation portion of that section. However, the Commission retains authority to construe and define the nature and scope of what constitutes special compensation under Section 202(a)(11)(B) itself, something it did not purport to do in *Financial Planning Association.* Even if in some prior interpretations the Staff has taken a broad view of what constitutes special compensation, the Commission has the authority to revisit and update those prior interpretations in light of new market developments like MiFID II and the evolution of its experience and expert judgment.[19]

Here, the payments are limited to a purpose, research, which Section 28(e) of the Exchange Act expressly intends to be provided by broker-dealers. All that is happening is that the asset manager would be permitted to direct the commission related amounts to the research providers the adviser deems most valuable for its investor clients. This is an outcome that promotes both transparency for the asset manager's activities but independence with respect to research. Both of those concepts have been at the forefront of regulatory focus. There would be no added regulatory value by layering on investment adviser regulation on these payments, and as explained above, there would be a substantial loss in value by removing the existing scheme of broker-dealer research regulation.

Moreover, exemptive or other relief here would be much narrower than the rulemaking at issue in *Financial Planning Association.* It would not allow the establishment of fee-based accounts in which individualized investment advice is provided. Instead, it would allow for broker-dealers to disseminate generalized research to their brokerage customers. Indeed, research reports

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[17] *See, e.g.*, Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules, December 2005, *available at* https://www.sec.gov/rules/sro/finra/2014/34-73623-ex3b.pdf, at 25-26; Paul Clarke, *Investment Bank Research Teams Suffer Deepest Job Cuts*, FINANCIAL NEWS, February 27, 2019, *available at* https://www.fnlondon.com/articles/investment-bank-research-teams-bear-the-brunt-of-job-cuts-20190227.

[18] *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

[19] *See* SEC Press Release: SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions, October 27, 2017, *available at* https://www.sec.gov/news/press-release/2018-301 (monitoring and assessing the impact of MiFID II on broker-dealers and investment advisers).

are defined as communications that are sent to 15 or more persons. Thus, it is abundantly clear the impersonal nature of these communications renders them fundamentally different from the customized advice provided in fee-based accounts. Here, the research is both incidental to brokerage services and is not individualized investment advice. Finally, to the extent the Staff issues "no-action" relief, as it already has done in the current SIFMA No-Action Response, that relief would neither preclude a more expansive review of regulatory landscape through a rulemaking, nor would it be a final agency action subject to challenge in the courts.[20]

Conclusion

To conclude, we believe the law authorizes the Commission to permit broker-dealers to accept hard dollars from money managers for research services. Both sound policy and precedent support that course. The Commission has the tools to craft targeted relief to accomplish that legally well-founded and common sense policy outcome. To do otherwise, would complicate and increase the costs of compliance, and more importantly, undermine investor protection.

Sincerely,

James Brigagliano
Partner

Hardy Callcott /by JAB

W. Hardy Callcott
Partner

cc: Hon. Robert J. Jackson Jr., Commissioner
Hon. Hester M. Pierce, Commissioner
Hon. Elad L. Roisman, Commissioner
Dalia Blass, Director, Division of Investment Management
Brett Redfearn, Director, Division of Trading and Markets
Elizabeth Baird, Deputy Director, Division of Trading and Markets
Paul G. Cellupica, Chief Counsel and Deputy Director, Division of Investment Management

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[20] *See* SIFMA No-Action Response, *supra* note 1 (stating the SEC's no-action letter represents the SEC's "position on enforcement action and does not purport to express any legal conclusion on the questions presented").