April 2, 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, Including Reforms Arising From MiFID II

Dear Chairman Clayton,

We write to share with you key issues regarding best execution and payments for research, including the impact on investors and market participants in the US from the Europeans' adoption of Markets in Financial Instruments Directive (MiFID) II.[1]

While we agree with many of the objectives of MiFID II's best execution and research payment provisions, we do not believe that Europe's regulatory interests represent the best interests for all US asset owners and investment advisers. However, modernizing best execution obligations for investment advisers and promoting transparency in costs serves to benefit investors, boosting the savings of millions of American families and businesses. In that vein, we encourage the Commission to consider:

- Adopting guidance for investment advisers that would -- for the very first time -- clearly outline their best execution obligations;
- Adopting already proposed order routing and venue disclosure reforms that will provide investment advisers and asset owners with standardized trading data necessary to analyze their costs and evaluate their (and their service providers') trading performance; and

[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.

- Revising the recently-granted “no action” MiFID II relief to make it clear that:
    - If an investment adviser purchases research that benefits both US and non-US customers, payments for that research must be allocated on a fair and reasonable basis;
    - No US-based customer assets are used to pay for research that exclusively benefits non-US asset owners; and
    - If a research provider is willing to accept direct hard-dollar payments for research in the US or abroad, for whatever reason, that research provider must be willing to accept such hard dollar payments from US-based investment advisers, subject to such other reasonable requirements as the provider imposes upon its other “hard dollar” customers (in the US or abroad).

While the Commission’s recent MiFID II-related “no action” relief provided some much-needed comfort for US firms, it also exacerbated some of the worst aspects of the intersection between the US and European rules. Unfortunately, we worry that rather than shielding US-based firms from negative impacts of MiFID II, the Commission has complicated matters, while also subjecting US asset owners to greater risks and costs. There are many unintended consequences of the Commission’s recent actions. One that we find most troubling is that, when combined with MiFID II rules, US asset owners may be forced to pay for the cost of research that does not benefit them in any way, including the cost of research for European asset owners.

We urge you to not allow European regulations to disadvantage US asset owners, investment advisers, and independent research providers. If the United States is to continue its position as the global capital markets leader, we must continue to serve as a leader in protecting investors.

About Healthy Markets

The Healthy Markets Association is an investor-focused, not-for-profit coalition working to educate market participants and promote data-driven reforms to market structure challenges. Our members, who range from a few billion to hundreds of billions of dollars in assets under management, have come together behind one basic principle: Informed investors and policymakers are essential for healthy capital markets.[2]

[2] To learn more about Healthy Markets or our members, please see our website at http://healthymarkets.org.

Background on Best Execution and Payments for Research

Investment advisers have a duty of best execution when trading on their clients' behalf.[3] However, there is no clear directive in statute or rule for an investment adviser to seek best execution.[4] Instead, investment advisers' best execution obligations arise from and are shaped by a loose combination of interrelated rules and case law, most notably:

- brokers' analogous "best execution" obligations;
- advisers' statutorily imposed fiduciary duty to act in their customers' best interests;
- a collection of regulatorily-mandated disclosures; and
- enforcement cases.[5]

The duty of best execution for investment advisers is almost completely undefined. For example, there is no specific requirement that investment advisers have best execution committees, or engage in any other specific practices to meet their duty.

Many investment advisers' "best execution" practices arise out of their required disclosures. For example, Item 12 of Form ADV Part 2A requires investment advisers to "[d]escribe the factors that you consider in selecting or recommending broker-dealers for client transactions and determining the reasonableness of their compensation (e.g.,

---

[3] SEC, *General Information on the Regulation of Investment Advisers*, *available at* https://www.sec.gov/divisions/investment/iaregulation/memoia.htm (last viewed 12/31/15). It has become generally accepted by many lawyers and other market participants that the Investment Advisers Act of 1940 has a directive for advisers to achieve best execution. See, e.g., Investment Company Institute, Frequently Asked Questions About "Best Execution", *available at* https://www.ici.org/policy/regulation/advisers/faqs_best_execution ("Under the Investment Advisers Act of 1940, every registered investment adviser, including an investment adviser to a mutual fund, has a duty to obtain "best execution" on all securities transactions for their clients."). Hereinafter, we will refer to these duties as "best execution" responsibilities, even though, technically, they arise as a result of advisers' fiduciary duties, and not, strictly speaking, from the broker-dealers' more directly regulated "best execution" responsibilities. See FINRA, *Rule 5310: Best Execution and Interpositioning*, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10455.

[4] The phrase "best execution" appears nowhere in the Investment Advisers Act of 1940. The word "best" appears just once in the Act. Under recently enacted Section 211(g), the Commission is authorized to promulgate rules to require investment advisers, brokers and other firms to "act in the best interest of the customer" "when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide)." Investment Advisers Act of 1940, Section 211(g). The legislative history and subsequent rulemaking efforts in this area appear to be centered on imposing a fiduciary duty on broker-dealers similar to that already resting with investment advisers.

[5] For a more thorough review of "best execution" obligations for investment advisers, please see the most-recent edition of Better Best Execution. Healthy Markets Association, *Better Best Execution: A Guide for Investment Advisers*, (2017), *available at* https://www.healthymarkets.org/better-best-execution-report.

commissions)."[6] There is no specification on what those factors must entail, however.[7] Many advisers also disclose their commitment to achieve best execution and the factors used by their advisers to select brokers to effectuate the funds' transactions.

In addition, registered investment companies, including mutual funds and closed-end funds, are required to provide statements of additional information ("SAI") to supplement the information described in the fund's prospectus.[8] The SAI requires a description of the fund's brokerage allocation and other practices that may impact best execution.[9]

These factors often include: price; costs; speed; likelihood of execution and settlement; size; nature; and anything else the firm deems relevant to the execution of an order. They may also include provision of research.

---

[6] Item 12 of Form ADV Part 2A.

[7] For example, under MiFID, investment advisers in Europe must evaluate factors like price; costs; speed; likelihood of execution and settlement; size; nature; and anything else that might be relevant to the execution of an order.

[8] See, e.g., Selected Funds, Selected Funds SAI (Dec. 22, 2015), *available at* http://selectedfunds.com/downloads/SFSAI.pdf ("With respect to securities transactions for the portfolios, the Adviser determines which broker to use to execute each order, consistent with its duty to seek best execution of the transaction."; see also Westport Funds, Westport Select Cap Fund SAI (May 1, 2009) *available at* http://www.westportfunds.com/files/SAI.pdf, ("In placing orders for portfolio securities of the Funds, the Adviser is required to give primary consideration to obtaining the most favorable price and efficient execution. Within the framework of this policy, the Adviser will consider the research and investment services provided by brokers or dealers who effect, or are parties to, portfolio transactions of the Funds or the Adviser's other clients. Such research and investment services are those which brokerage houses customarily provide to institutional investors and include statistical and economic data and research reports on particular companies and industries. Such services are used by the Adviser in connection with all of its investment activities, and some of such services obtained in connection with the execution of transactions for the Funds may be used in managing other investment accounts. Conversely, brokers furnishing such services may be selected for the execution of transactions of such other accounts, and the services furnished by such brokers may be used by the Adviser in providing investment management for the Funds. Commission rates are established pursuant to negotiations with the broker based on the quality and quantity of execution services provided by the broker in light of generally prevailing rates. The Adviser's policy is to pay higher commissions to brokers for particular transactions than might be charged if a different broker had been selected on occasions when, in the Adviser's opinion, this policy furthers the objective of obtaining the most favorable price and execution. In addition, the Adviser is authorized to pay higher commissions on brokerage transactions for the Funds to brokers in order to secure research and investment services described above, subject to review by the Board of Trustees from time to time as to the extent and continuation of the practice. The allocation of orders among brokers and the commission rates paid are reviewed periodically by the Board of Trustees.").

[9] See Form N-1A, Item 21.

Advisers must also clearly disclose and adequately explain their actual and potential conflicts of interest with respect to their trading practices.[10] Trading conflicts that may impact best execution include:

- the use of an affiliated broker on an agency or principal basis;
- research and/or brokerage obtained through soft-dollar arrangements; and
- interest in, or material business relationships with, broker dealers, including use of brokerage to recognize sales and distribution activities of broker-dealers and their affiliates for products offered advised by the adviser or its affiliates.

Since 1975, Section 28(e) of the Securities Exchange Act of 1934 has provided a safe harbor wherein, provided certain conditions are met, investment advisers will not be deemed to be acting unlawfully or in breach of their fiduciary duties (of best execution) solely on the basis that they use client commissions to pay brokers for research.[11] Thus, while there is no guidance on what an investment advisers' best execution obligation entails, there is guidance on what does not violate it--reasonable payments for research.

Cutting Costs: Limitations to the Existing Best Execution Framework

For decades, investment advisers and asset owners have worked to identify and reduce their "execution" costs.[12] In fact, in their quest to fulfill their fiduciary duties as well as respond to competitive pressures, asset owners and investment advisers are increasingly utilizing sophisticated analytical tools to evaluate trading execution performance and costs.[13] Combined with numerous regulatory and market innovations, institutional investors' execution costs have fallen dramatically over the past several decades.

However, one cost center has not kept up with these pressures: payments for research.

Essentially, research is often 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

---

[10] See Lori Richards, Director, Office of Compliance Inspections and Examinations, Sec. and Exch. Comm'n, Before the Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006), *available at* https://www.sec.gov/news/speech/spch022706lar.htm; See also: CFA Institute, Trade Management Guidelines (Nov. 2002), *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n3.4007.

[11] Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78bb(e).

[12] Modern Transaction Cost Analysis dates back to the mid 1980's when investors began to benchmark trading against Volume Weighted Average Price of the underlying security.

[13] Healthy Markets Association, *Better Best Execution: A Guide for Investment Advisers*, (2017), *available at* https://www.healthymarkets.org/better-best-execution-report.

very basic level, for example, there is no requirement in the US that the research benefit the asset owner whose assets are being used to pay for it.

For example, assume that an investment adviser manages two funds: one small-cap fund and a separate mid-cap fund. The adviser consumes extensive third-party research for its small-cap fund, but doesn't for its mid-cap fund. However, its small-cap fund doesn't trade in significant volumes. In this scenario, it would be possible for the adviser to pay for that research by sending bundled trades to the broker/research provider for the pure mid-cap fund. In this case, the adviser has made the decision to directly use the assets of the mid-cap fund (i.e., its asset owners) to pay for expenses incurred to benefit the small-cap fund. These could be different asset owners. Of course, research may more directly benefit one fund or set of customers than another, but still benefit both. But drawing lines of distinction may prove difficult.

Similarly, while the payments must be "reasonable", there is also no regulatory requirement that the amounts of payments be tied to the value of the research provided. For example, assume an investment adviser has a $2 billion fund that, in a year, traded 50 million shares. Assume further that the fund received equal research and trading execution services from 10 brokers (i.e., each provided equivalent research and traded 5 million shares). All of the shares were traded at commission rates of 4 cents a share, with half attributed to the executions and half for the research. All of the $2 million in bundled commissions is paid from the fund, with $1 million being paid for the executions and the rest for the research.

Then, the following year, the firm got a new portfolio manager who decided to trade 100 million shares. The adviser received the same exact amount of research from the same 10 brokers, and paid the exact same bundled commission rate of 4 cents per share. Only this time, the fund paid $4 million in bundled commissions, with $2 million attributed to executions and the other $2 million for research. While the increased costs attributed to the increased trading makes sense (brokers should be paid for their work), the increased payments for the research does not. In this case, just because the fund traded more, the brokers got paid $1 million more than they had the year before for the same volume and quality of research.

Of course, this argument could also hold in reverse. What happens when an investment adviser trades dramatically less than it has in the past? Or notional value-linked commissions go down with asset prices? Or if the research informs a decision to not trade at all? The research may be extremely valuable for the investment adviser, and ultimate asset owner, but the payment to the research provider in these scenarios may be

extremely limited. These scenarios may moderate what otherwise might be viewed as potentially higher research payments over time.

This type of arrangement, where brokers are paid for research in amounts that are dependent upon the volume of trading by the adviser--as opposed to the true value of the actual research provided--has been historically prevalent in the US.[14]

Similarly, commissions in some products (or in securities outside of the United States) may be based on the underlying market value of the underlying trade. In these instances, changes in the market values of those financial products could dramatically impact the commission amounts attributed to trades. For example, as European asset prices generally rose in 2017, payments for research for some asset owners rose commensurately. Again, why is it that the compensation to research providers should change merely because of changes in the value of the underlying transactions? The research itself hasn't changed.

There are also significant concerns about what is actually categorized as "research." For example, in the United States, a broker providing "access" to corporate executives is considered "research", while in the United Kingdom it is not.[15] For example, assume a US-based investment adviser is introduced to an executive team of a Chinese technology company by a broker-dealer. That adviser could, under existing US rules, "pay" that broker-dealer for that "research" by directing trades from a purely US-based fund. Again, the US customers could be subsidizing other customers for the adviser.

At the same time, the bundling of research and execution payments has had a dramatic impact on research providers and investment advisers. Some large research providers have traditionally expected investment advisers to pay for that research by sending them orders for execution. This benefits the research providers with increased trading volumes.

Unfortunately, investment advisers and asset owners may have to choose between getting the research they need and the ability to shop for potentially higher quality or lower cost executions. This poses significant challenges to investment advisers seeking to fulfill their best execution obligations. Again, we hope the Commission is able to help

---

[14] In many instances, firms will engage in a voting practice wherein traders and portfolio managers will rank and weight brokers for research and execution values based on objective and subjective criteria, and then attempt to "direct" their overall trading activities (and "commission wallet") to those brokers in those ratios.

[15] When explicitly denying "corporate access" as a permissible use of client funds, the Financial Conduct Authority found "[n]one of the investment managers we visited could justify to us how Corporate Access met the evidential criteria for research under our rules to allow them to pay for it with dealing commissions." 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.

empower these advisers to more effectively separate the research valuation and payment decisions from the decision of where to trade.

Further, smaller, independent research providers who may have no or limited trading capabilities may never have a realistic opportunity to provide their research to investment advisers because of how they are compensated. These smaller, independent firms often require payment by checks or hard dollars, which are typically paid by the investment advisers themselves, as opposed to their asset owners. Put simply, an adviser may be forced to choose between research from a full service broker dealer for which it may bundle the the payments (and won't pay directly), and perhaps better research from an independent firm (which it will pay for out of its own pocket).

The cost burden is borne directly by the fund's asset owners in the first instance, while it is borne by the investment adviser in the latter. Investment advisers--particularly smaller advisers with slim margins--are often compelled by business necessity to choose the bundled option.

In recent months, some market participants (particularly large broker/research providers) have argued that unbundling the pricing and payments for research from trading will decrease the provisions of research into small and medium-sized companies. This argument appears to largely rest on the assumption that the additional trading revenues are essentially subsidizing the provision of research into these companies.

In reality, nearly the opposite outcome is more likely. Currently, in the United States, it is the smaller, independent research firms that typically provide the essential research for smaller companies that are often less likely to be covered by research analysts at the bulge bracket firms.

Bundled commissions thus create a concrete conflict of interest that favors the largest broker-dealer research providers, stifles competition in research provision, and reduces diversity of research provision--particularly in smaller and mid-cap companies. In all of these instances, there are significant questions about whether these practices are in the best interests of all of a brokers' or investment advisers' customers.

Not surprisingly, regulators, asset owners, and some investment advisers have asserted that paying for research with commission dollars could give rise to conflicts of interest and higher costs. Nevertheless, soft dollar payments for research are still a crucial part of many US investment advisers' -- and research providers' -- businesses.

European Review of Best Execution and Payments for Research

European regulators have spent more than half a decade exploring asset managers' best execution obligations and how they are (or more importantly, aren't) fulfilling them. After years of study, the regulators have adopted new business conduct rules that are quickly changing business practices around the globe.

More than six and a half years ago, during the course of its examinations, 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.[16] It began a comprehensive review, and in November 2012, released a report on conflicts between asset managers and their customers, as well asset managers' treatment of their different customers.[17]

One of the most troubling findings in that report was that the FSA found "breaches of our detailed rules governing the use of customers' commissions and the fair allocation of trades between customers."[18] 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 unable to demonstrate … how items of research met the exemption under our rules and were in the best interests of their customers."[19]

Put simply, it 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.

---

[16] 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.
[17] *Id.*
[18] *Id*, at 4.
[19] 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.

European Regulators Revise Rules for Best Execution and Payments for Research

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."[20] In July 2014, the FCA followed up the rules changes with a report on best execution and payment for order flow,[21] as well as a discussion paper on asset managers' use of commissions.[22]

In the meantime, on a parallel track, the European Commission adopted significant reforms as part of the June 2014 Market in Financial Instruments Directive (MiFID) II.

European rules historically required brokers and investment advisers to engage in "all reasonable steps" to ensure best execution. Under MiFID II, which officially took effect on January 3, 2018, that standard was raised significantly to "all sufficient steps." This change raised the expectation from simply having a reasonable process, to having a process that actually achieves a specific result.

Further, 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] 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.

[21] 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.

[22] 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.

US Regulatory Response to European Rules -- "No Action" Letters

The changes imposed by MiFID II are dramatically changing expectations for best execution around the globe. In the US, however, these changes have been met with mixed reactions. Some investment advisers are quickly reconciling their practices to comply with the new rules, while others are not. Still other advisers are building hybrid models.

Reconciling the disparate regulatory expectations has been challenging. As the January 2018 deadline for MiFID II compliance approached, SIFMA,[23] SIFMA AMG,[24] and ICI[25] each petitioned the SEC for "relief" from various conflicts between the new European research payment regime and the existing US regime. These requests sought to address some pragmatic challenges for broker-dealer research providers and investment advisers.[26]

[23] Letter from Steve Stone, Morgan Lewis (on behalf of SIFMA) to Douglas Scheidt, SEC, Oct. 17, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a-incoming.pdf.

[24] Letter from Timothy W. Cameron and Lindsey Weber Keljo, SIFMA AMG, to Heather Seidel, SEC, Oct. 25, 2017, *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf.

[25] Letter from Dorothy Donohue, Investment Company Institute, to Douglas Scheidt, SEC, Oct. 20, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1-incoming.pdf.

[26] See, e.g., Letter from Steve Stone, Morgan Lewis (on behalf of SIFMA) to Douglas Scheidt, SEC, Oct. 17, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a-incoming.pdf (seeking assurances that the SEC staff "will not recommend that the Securities and Exchange Commission ("SEC") take enforcement action under the Investment Advisers Act of 1940 ("Advisers Act") against certain broker-dealers that provide research services that constitute investment advice under Section 202(a)(11) to an investment manager that is required under [MiFID II], either directly or by contractual obligation, to pay for the research services from its own money, from a research payment account ("RPA") funded with its clients' money, or a combination of the two."

The SEC staff generally granted the “no action” relief sought by the three groups, and thus resolved some of the key issues for brokers and investment advisers.[27] However, the “no action” “relief” also createdsome troubling unintended consequences. Notably, it:

- Created the opportunity for, and potentially permitted, investment advisers to shift research costs from their European customers onto their US asset owners;
- Permitted some research providers to force US asset owners (as opposed to investment advisers) to continue paying for the research out of their returns;
- Permitted some research providers that provide important research to expect order flow and executions from their US-based investment adviser customers--even if the execution costs are higher or quality is lower than could otherwise be found; and
- Systematically disadvantaged smaller investment advisers and others who are more dependent upon third-party research--both in their trading costs and overall returns for their underlying asset owners.

Collectively, this staff-level guidance from the SEC offered some clarifications on how to reconcile their US and European requirements. However, investment advisers--particularly those operating in both the US and Europe--still have numerous questions on how to reconcile the now incompatible regimes, including:

- How do you value “research” for which there is no given price?
- How do you value “research” for which the given price is too low?
- Can you allocate research costs on a firm-wide basis?
- Can you allocate on a strategy-wide basis?

[27] See, Letter from Elizabeth Miller, SEC, to Steve Stone, Morgan Lewis (on behalf of SIFMA), Oct. 26, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm (granting, for 30 months, assurances that the SEC staff wouldn’t recommend action “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.); 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 (granting assurances the SEC staff wouldn’t recommend action “against a money manager seeking to operate in reliance on Section 28(e) of the Exchange Act if it pays for research through the use of an RPA, as described in your letter and conforming to the requirements for RPAs in MiFID II, provided that all other applicable conditions of Section 28(e) are met.”); Letter from Aaron Gilbride, SEC, to Dorothy Donohue, ICI, Oct. 26, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm (granting assurances that the SEC staff woudn’t recommend action “against an investment adviser that aggregates orders for the sale or purchase of securities on behalf of its clients in reliance on the position taken in SMC Capital while accommodating the differing arrangements regarding the payment for research that will be required by MiFID II.”) (citing to Letter from Karrie McMillan, SEC, to SMC Capital, Inc., Sept. 5, 1995, *available at* https://www.sec.gov/divisions/investment/noaction/smccapital090595.htm.).

- How do you allocate research costs between US and EU clients in same strategy?
- What about “corporate access” (which is not “research” in the UK)?
- Can you utilize an aggregator for RPAs to operate similarly to existing practices in the US?
- How do you trade, fairly allocate, and accurately disclose costs for research when some US asset owners demand that you pay for research with hard dollars while other asset owners are willing to continue to have their funds pay through soft dollars?
- How do you ensure “best execution” for bundled commissions when other customers are paying for no research in the same strategy?

What’s Happening Now?

The best execution and research provisions of MiFID II are already spreading around the globe--and the regulatory expectations are almost certain to follow. MiFID II is pushing firms operating in Europe to use Research Payment Accounts or pay directly in hard dollars, and that is impacting the US. As with every industry-wide change, some firms are on the leading edge, while others are more reluctantly following; forced by regulatory and client pressures. In general, investment advisers are increasingly:

- 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.

Some firms are dramatically altering how they budget and pay for research. Historically, many investment advisers have allocated out their “research” payments on a broker-by-broker basis as a percentage of their overall trading levels. The percentages were often determined by some voting or assessment process. Many firms are changing this practice.

Alternatively, some investment advisers are having their funds’ boards or the advisers’ management teams set explicit research budgets on a portfolio basis. Some are seeking to allocate out to clients the projected costs for research on a forward-looking basis (much like a RPA). Other firms are still not setting hard research budgets, but are nevertheless

turning to commission sharing arrangements, and may even be looking to reimburse their customers' funds for the costs of research paid.

Several large, US-based investment advisers have also recently announced that they intend to respond to the new rules by directly paying for research for their European customers, while treating their US customers differently.[28] In Europe, those costs would be borne by the investment advisers or the advisers' other customers. In the US, asset owners will likely continue to absorb those costs directly. They may also be denied the opportunity to have their advisers pick up the costs directly through "hard dollar" payments.

We at Healthy Markets have no opinion as to whether asset owners or investment advisers should directly bear the costs for investment research. We do, however, strongly believe that the costs of research and execution should be clearly identified and transparent for asset owners in a standardized way that is comparable across different adviser firms. If asset owners are required to pay directly for research, the research provided should actually be to their -- as opposed to other investors' -- benefit. That is one of our primary concerns with the current interaction between the US and European rules.

The Europeans have exploited a weakness in U.S. rules that systematically advantages European asset owners at the expense of US asset owners.

Suppose a global investment adviser has both European and US customers. The investment adviser could potentially shift the costs of research that benefits its European asset owners onto its US-based asset owners. And the global investment adviser is strongly incentivized to do that, because any costs that are not so-shifted will now fall to it.

Some research providers have reportedly responded to MiFID II by offering their research services in Europe at very low costs, often fractions of what they had been compensated for those same services months earlier. This will benefit the firms' investment advisory clients, particularly those who have committed to paying out of their own assets for research. On the other hand, these research providers will still expect to be compensated. As a result, many have speculated that these firms will be paid through receipt of more executions and, more disturbingly, through bundled commissions arising from trading by non-MiFID-covered customers ("cross-subsidization"). In fact, we at Healthy Markets are aware of at least one global bank/research provider explicitly advising a US-based investment adviser of this "cross-subsidization" payment option.

---

[28] *See, e.g.*, Chris Flood, *BlackRock to foot bill for external research under Mifid II*, Financial Times, Sept. 14, 2017, *available at* https://www.ft.com/content/fb9e2552-9939-11e7-a652-cde3f882dd7b.

While the European regulator with primary jurisdiction, ESMA, is exploring whether these prices are artificially low or otherwise may constitute a prohibited "inducement" for trading, the regulator's authority and willingness to address the issue may be limited.

Interestingly, some smaller investment advisers have decided to try to pay for research directly, but have been frustrated in these efforts. In fact, some bank/research providers that have previously been willing to accept hard dollar payments for research have begun to deny smaller investment advisers that ability. As a result, if the investment adviser is to get the needed research, then it will have to trade with the bank/research provider. In this case, then the asset owner would pay for the research and the execution. And even if the investment adviser subsequently reimburses the asset owner for the research costs, the asset owner may still lose out because of lower quality executions. Put simply, trading in a bundle and then having the investment adviser reimburse asset owners for research costs after the trade is not the same as permitting the adviser to shop separately for the costs and paying for them separately.

We are confident that many more subtle changes and trends are occurring, and we hope the Commission is able to monitor them.

What's Next?

Much like a tidal wave crashing onto a beach, we expect the best practices and obligations arising from MiFID II to eventually hit all US advisers.

We expect the heightened expectations around all aspects of the order life cycle (from idea generation to order execution to execution and research evaluation to modifications) will likely become integrated by global advisers, where they will spread to other advisers as a "best practices." Those provisions will not just impact investment advisers' trading processes, but also their payment for research.

Unfortunately, the process of reconciling and meeting different regulatory obligations and changing customer expectations is both costly and inconsistent. This situation is made worse by the fact that the Commission has never clearly articulated the parameters and expectations for best execution for investment advisers. Without a clear set of expectations, firms are aiming blindly towards an unknowable target for "best execution." Practices and standards are being developed based on financial firms' varied levels of expertise, legal risk appetite, customer relationships, and even their customers' sophistication levels.

Some investment advisers are engaging in massive overhauls of their order routing, execution, and analysis systems. Some are spending millions of dollars engaging in cutting-edge transaction cost analysis and adjusting trading decisions based on nearly real-time market information. Some are developing or acquiring sophisticated programs that help them identify, value, and track research throughout the investment decision life-cycle. Some firms have best execution committees that meet monthly or quarterly and cover a slew of key market and regulatory information. Some firms have been engaging in all these practices for years. And still some firms are doing none of these things.[29]

Unfortunately, the disclosures required by the Investment Advisers Act and the Investment Company Act would likely be remarkably similar for firms at either end of this spectrum. This inconsistency also leaves asset owners exposed to greater costs and risks, but without any reasonable way for them to differentiate or identify the differences.

We remain particularly concerned with potential legal exposure for investment advisers. Unfortunately, it isn't clear to what standard investment advisers' best execution and research payment practices are to be held. We believe it is increasingly likely that asset owners may pursue private legal action against investment advisers for somehow failing in their duties.

Recommendations

Healthy Markets recommends that the Commission:

- Adopt guidance for investment advisers that would -- for the very first time -- clearly outline their best execution obligations;
- Adopt the already proposed order routing and venue disclosure reforms that will provide investment advisers and asset owners with the standardized data necessary to analyze their trading costs and evaluate their (and their service providers') trading performance across venues on an apples-to-apples basis; and
- Revise the recently-granted "no action" relief to make it clear that:
    - If an investment adviser purchases research that benefits both US and non-US customers, payments for that research must be allocated on a fair and reasonable basis;

[29] The legal, compliance, technological, and trading costs associated with all of these changes are significant.

- No US-based customer assets are used to pay for research that exclusively benefits non-US asset owners; and
- If a research provider is willing to accept direct hard-dollar payments for research in the US or abroad, for whatever reason, that research provider must be willing to accept such hard dollar payments from US-based investment advisers, subject to such other reasonable requirements as the provider imposes upon its other "hard dollar" customers.

The guidance to investment advisers is particularly critical. This long-overdue guidance should delineate basic principles and expectations for best execution (e.g., periodic reviews of execution quality; best execution committees; policies, procedures, and practices across asset classes; etc.), and should also include a reiteration of the purposes of the statutory permission for soft dollars. This should include explicit support for diversity of research and diversity of research providers, as well as the impacts on smaller investment advisers. Without a clear standard from the Commission, we fear that asset owners, investment advisers, and even the courts may be left to determine their own -- likely different -- standards.

Conclusion

US-based research providers, investment advisers, and asset owners are already dramatically impacted by the implementation of MiFID II. We urge the Commission to consider actions to protect US asset owners from being disadvantaged by European rules, and ensure that US investment advisers are able to freely shop for the best research and executions available.

We encourage the Commission to begin leading the charge towards developing intelligent, world-wide standards and best practices to ensure the US capital markets remain the most liquid and vibrant in the world.

Thank you for your consideration.

Sincerely,

Tyler Gellasch

Executive Director

Cc: Hon. Kara Stein, Commissioner
Hon. Michael Piwowar, Commissioner
Hon. Hester Peirce, Commissioner
Hon. Robert Jackson, Jr., Commissioner
Brett Redfearn, Director of the Division of Trading and Markets
Dalia Blass, Director of the Division of Investment Management