Sent via Email

January 31, 2019

Hon. Jay Clayton, Chairman
Hon. Robert J. Jackson Jr., Commissioner
Hon. Hester M. Peirce, Commissioner
Hon. Elad L. Roisman, Commissioner
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

*RE: Asset Owner's Perspective of MiFID II's Impact on Research Provisions*

Dear Commissioners:

On behalf of Colorado Public Employees' Retirement Association[1] ("PERA"), we are respectfully conveying our perspective, as a U.S. asset owner, on Markets in Financial Instruments Directive II ("MiFID II") and its impact on U.S. equity markets. While we commend the Securities and Exchange Commission ("SEC") staff on implementing a temporary "solution" via the SIFMA Letter issued in 2017[2], we once again request (*see attachment for PERA's September 2017 letter*) that the staff of the SEC take action to allow U.S. investment managers and asset owners to fully "unbundle" their trade execution from research. Without this action, U.S. investors remain at a disadvantage to their European peers.

While the SIFMA Letter granted temporary no-action assurances concerning the Advisers Act to broker-dealers that receive payments in hard dollars or through MiFID-governed research payment accounts from MiFID-affected clients, U.S. investors (who are not subject to MiFID II) are excluded from this narrow relief. By not granting no-action relief to *all* firms, the SEC is allowing broker-dealers to "force" the continued practice of bundling research with execution (i.e., using commissions to pay for research). Our experience has been that, referencing the narrow scope of this no-action relief, these same broker-dealers are not allowing U.S. investors to pay directly for research. For example, PERA uses a U.K.-based external equity manager that pays a certain U.S.-based bulge bracket broker directly for research. That same broker will not accept direct payment from PERA for research, citing requirements under the Advisers Act. This divergent treatment creates an unlevel playing field, potentially disadvantaging U.S. investors in their efforts to seek best execution in trading and transparency in research acquisition. We believe an urgent need exists to align market practice in this arena with our European peers, thus we again advocate for the Commission to take action to permit full unbundling by investors. Ideally, we would like

[1] PERA is a U.S.-based asset owner with approximately $45 billion in assets under management. PERA provides retirement and other benefits to more than 600,000 current and former teachers, state troopers, corrections officers, and other Colorado public employees.

[2] Includes defined benefit assets only. Consists of $10 billion in actively managed equities and $8 billion in passive equities.

the no-action relief to cover *all* investors, regardless of their status under MiFID II[3]. If that is not practicable, another option is to immediately rescind the SIFMA Letter, which would then drive consistent treatment of clients by broker-dealers.

As an asset owner that is also a direct equity investor, internally managing $18 billion in global equities[4], we are a unique market participant (i.e., we directly consume sell-side research in managing our active internal equity funds, while also benefitting from such research used by our external equity managers). Due to this distinctive perspective, we are especially mindful of MiFID II's impact on research and trading. We believe many of our asset owner peers, especially those that do not directly manage money, may be less familiar with the consequences of MiFID II for U.S. investors.

**Investor Impact of MiFID II**

European asset owners have long been concerned that investment managers have not been judicious in controlling costs for research and trading. To address these concerns, a central goal of MiFID II is to improve transparency of costs, thus potentially delivering greater value to asset owners/investors. By requiring the separation of the cost of trade execution from that of research, MiFID II has increased transparency and price discovery for research, benefitting European investors.

**Direct Procurement of Research**

In conjunction with the implementation of MiFID II, PERA has been working to unbundle its own equity commissions and research payments through direct negotiations with broker-dealers. As a result, PERA experienced improved transparency of research pricing and a more direct focus on best execution, starting in 2018. This has allowed for greater efficiency in resource allocation related to research and trading, to the benefit of PERA and its members. These benefits, however, have been unnecessarily limited. Due to the narrow scope of the no-action relief provided to broker-dealers, PERA has been unable to completely unbundle and pay for research separately from trade execution. Consequently, PERA and other U.S.-based investors (not subject to MiFID II) remain at a disadvantage relative to their European peers, as U.S. investors are not fully allowed to seek the best provider of research, independent of trade execution. In addition, U.S. investors are not fully allowed to seek the best provider of trade execution, independent of research.

Whereas Europe's investors are fully benefiting from the complete unbundling and transparency dictated by MiFID II, U.S. investors are not wholly realizing these benefits, as they are not always permitted to purchase research in an unbundled and direct manner. We believe the method of payment, whether direct or commission-based, neither defines the research services provided by broker-dealers, nor represents "special compensation;"[5] the same research is provided regardless of payment choice. The difference is that, under the requirements of MiFID II, the explicit price of the research is established in advance, and paid for using clear, direct payments. In contrast, under the current bundled structure favored by numerous U.S. broker-dealers, the price of research is embedded in the cost of the trade and thus opaque to the investor. Our experience is that some broker-dealers continue to claim that they cannot accept direct payment for research from U.S. customers, as the current temporary relief granted by the SEC is

[3] If the SEC concludes it does not have the statutory authority to permit U.S. investors to unbundle trade execution from research, then the SEC should consider requesting such authority from Congress.

[4] Includes defined benefit assets only. Consists of $10 billion in actively managed equities and $8 billion in passive equities.

[5] Investment Advisers Act of 1940 - Rule 202(a)(11)

limited to MiFID-affected clients. This likely will remain the case in much of the U.S., unless the SEC takes action.

The economics of the bundled research model currently favor a handful of the largest "bulge bracket" firms, which can offer both research and trading services. Asset owners, (and their members, participants, etc.) not only pay the research costs (through commissions), but they may also absorb the costs of potentially inferior execution quality, as managers are forced to pay for research via trading commissions. We believe that unbundling will support the advancement of smaller sell-side firms that may specialize in research or execution, as opposed to the current result of promoting the aggregation of research and order flow into a handful of large brokers that provide both services.

**Research Purchased by Investment Managers Employed by PERA**

In addition to our direct experience negotiating unbundled arrangements for our internally-managed assets, PERA has experience with the competitive disadvantage current regulatory disparities create for U.S. investors relative to European peers in employing external investment managers. During 2018, PERA employed a U.S.-based equity manager that also had non-U.S. clients, which were subject to MiFID II and therefore prohibited from paying for research via traditional bundled commissions. As a result, this manager's U.S.-based clients were contributing "soft dollars" to pay for research through bundled equity commissions, while their European-based clients were not contributing at all, as their trades are executed at lower "execution-only" commission rates with no offsetting hard dollar expenditure from the manager. Consequently, U.S. investors, including PERA,[6] cross subsidized this manager's European clients, which benefitted from the same research but did not contribute to the research commission budget. Even if the manager paid out-of-pocket for the European clients' portion of the research budget (which they did not), then U.S. investors could still ultimately end up subsidizing research for European clients, as their payment into the "research pool" would continue to be opaque and less objective. This arrangement clearly puts U.S. investors at an unnecessary disadvantage. The SEC's implicit approval of cross-subsidization of research costs by U.S. asset owners stands in sharp contrast to the SEC's longstanding concerns with inappropriate cross-trades and trade allocations.[7]

**Recommendation**

We recommend that the SEC considers either declaring universal no-action relief under the Advisers Act related to broker-dealers that accept direct compensation solely in exchange for research, or rescinding the SIFMA Letter, as soon as practicable. U.S. investors should be able to separately identify and pay for research, while also seeking best execution for their equity orders. While we recognize that asset owners are the stakeholders benefiting the most from unbundling, we believe the time has come to evolve the ongoing practice within the U.S. of forced bundling of commissions; U.S. investors should not be at an unnecessary disadvantage relative to our European peers. Basic market fairness requires the consistent treatment of clients by broker-dealers. Upon implementation, global investors, as well as global research providers, would share a level playing field.

These necessary changes would have broad and significant ramifications for the modernization and efficiency of the capital markets in the United States. Unbundling is just an initial step in the evolving

[6] Manager is no longer employed by PERA.

[7] 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

transformation of equity research and trading. It is a precursor to the ongoing change necessary within the industry to support the investor community.

Please contact me with any questions at [redacted]. Thank you for your consideration.

Sincerely,

[redacted]

Amy C. McGarrity, CFA
Chief Investment Officer

COLORADO PERA®

September 22, 2017

Hon. W. Jay Clayton, Chairman
Hon. Michael S. Piwowar, Commissioner
Hon. Kara M. Stein, Commissioner
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: Implications and Recommendation Related to MiFID II Implementation

Dear Commissioners:

Colorado Public Employees' Retirement Association ("PERA") is a large U.S.-based asset owner, with approximately $47 billion in assets under management. As a large asset owner that is also a direct equity investor, internally managing over $18 billion in U.S. and non-U.S. equities, we are a unique market participant (i.e. we directly consume sell-side research, while also paying for such research via external managers).

On behalf of PERA, we respectfully request that the staff of the Securities and Exchange Commission ("SEC") consider granting no-action relief to broker-dealers under the Investment Advisers Act of 1940 ("Adviser Act"), thus allowing U.S. investment managers and asset owners to "unbundle" their trade execution from research. As you are aware, the European Union has adopted the Markets in Financial Instruments Directive II ("MiFID II"), which requires investment managers to pay for research services directly, via either their own money, or from a research payment account ("RPA") funded by its clients and/or its own money. We understand that certain broker-dealers are asking the SEC to refrain from taking enforcement action under the Adviser Act with specific regard to clients bound by MiFID II. These same broker-dealers have informed us that they will not allow U.S. investors, who are not subject to MiFID II, to pay directly for research. By foregoing universal no action relief, broker-dealers are forcing the continued practice of bundling research with execution (i.e. using commissions to pay for research), outside of MiFID II jurisdictions. We believe an urgent need exists to align market practice in this arena with our European peers, thus we advocate for the authorization of direct payment for research for all investors, including those not subject to MiFID II.

Investor Impact of MiFID II

As MiFID II separates the cost of trade execution from research, investors will benefit from increased transparency and price discovery for the cost of research. Pricing is already becoming more transparent, and a new competitive pricing dynamic is occurring globally. These developments foster more efficient allocation of resources related to research and trading, benefitting investors and asset owners. In addition, the unbundling of research costs and trading will facilitate independent research, thus improving market efficiency. This is all broadly positive

for European-domiciled investors, as the overall cost of research as well as trade execution (i.e. commission rates) should decline, post-MiFID II.

Our major concern is that U.S.-based investors, who are not subject to MiFID II, will be at a disadvantage relative to their European peers. Whereas Europe's investors will benefit from the unbundling and transparency dictated by MiFID II, U.S. investors will not realize these benefits unless they are permitted to purchase research in an unbundled and direct manner. We understand this requires the SEC granting relief from Section 28(e) of the Securities Exchange Act of 1934 which provides a safe harbor for managers to pay for research with commission dollars generated by account transactions. Under the Advisers Act, broker-dealers are prohibited from accepting direct payments for research, as defined under Section 202(a)(11), as this would be deemed "special compensation" and likely considered a "separate and identifiable charge".[1] We believe the method of payment, whether direct or commission-based, neither defines the research services provided by broker-dealers, nor represents "special compensation"; the same research is provided regardless of payment choice. The difference is that, under the requirements of MiFID II, the explicit price of the research is established in advance, and paid for using clear, direct payments. In contrast, under the current bundled structure favored by U.S. broker-dealers, the price of research is embedded in the cost of the trade and thus opaque to the investor. This likely will remain the case in the U.S. unless there is action, clarification, or declaration of "no-action" status.

Requiring the continued bundling of research and commissions for U.S. investors creates a competitive disadvantage relative to our European peers. We envision and believe a scenario will exist whereby an investment manager trades with a broker and is required to use hard dollars for their European client, yet is "required" (based on current interpretation) to use soft dollars for a U.S. client. The manager is making the same trade on behalf of both clients, and utilizing the same research. However, due to the transparency associated with the hard dollars, the U.S. investors could ultimately end up subsidizing research for European clients, as U.S. investor payment into the "research pool" is opaque and less objective. This clearly puts U.S. investors at an unnecessary disadvantage.

Recommendation

We believe that U.S. investment managers and asset owners should be able to separately identify and pay for the most valuable research, while also seeking best execution on their equity orders. We urge the staff of the SEC declare no-action relief under the Adviser Act related to broker-dealers who accept direct compensation solely in exchange for research. Additionally, we recommend that the Commission require consistent treatment of clients by broker-dealers (i.e. if accepting direct payments for research, including from MiFID II-subject customers, the broker-dealer must accept direct payments from all customers including U.S. managers and asset owners). Thus global investment managers and asset owners, as well as global research providers, would share a level playing field.

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[1] https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf, II(B)(3)

We recommend that at a minimum, the SEC declare temporary no-action relief as requested above, and immediately proceed to seek public comment on the topic. This very important issue has broad and significant ramifications for the modernization and efficiency of the capital markets in the U.S. and deserves discussion and feedback to consider multiple perspectives.

Please contact me with any questions at [redacted]. Thank you for your consideration.

Sincerely,

Amy C. McGarrity, CFA
Chief Investment Officer
Colorado Public Employees' Retirement Association