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April 2, 2019

The Honorable Walter Jay Clayton
Chairman
United States Securities and Exchange Commission
100 F Street, NE Washington, D.C. 20549-1090
Re: Public Comments from Interested Parties on MiFID II's Research Provisions

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Dear Chairman Clayton:

Morningstar welcomes the opportunity to comment on MiFID II's research provisions. Morningstar is committed to advancing the interests of investors. We have a long history of fighting for transparency in opaque areas of the capital markets. Part of the way we serve investors is by comparing mutual funds, and organizing and presenting key data to our clients. Given our experience in the European and American markets, we believe we have an important perspective on the challenges investors face given current soft-dollar disclosures and ways to adjust U.S. regulations so that they are better harmonized with European Union regulations to avoid unintended outcomes from the temporary relief the SEC has extended.

Current disclosures reveal little about the costs to investors from soft-dollar arrangements

U.S. soft-dollar disclosures are opaque, and the magnitude of any harms to investors from these arrangements can be difficult to discern. The only disclosures on commissions that mutual funds pay to execute trades are in absolute dollars on the statement of additional information, and these disclosures do not disaggregate between the cost of execution and the cost of research that broker-dealers may provide to mutual funds as part of their fees for executing a trade.

Investors cannot glean much information on a fund's brokerage costs relying on disclosures of commissions in absolute dollar terms because such information tells them very little about the extent to which trading costs reduced their returns as investors in the fund. At best, an investor could calculate a fund's brokerage costs using the dollar value of commissions divided by the average assets under management for the period, the method Morningstar uses. However, this calculation would not accurately reflect the actual reduction in returns due to commissions because the timing of the commissions throughout the year is unknown, and investors would need to make similar calculations on comparable funds to understand if the trading costs in their funds were unusually high.

Little is known about the extent to which soft dollars reduce returns for investors because these costs are not disaggregated from the costs of commissions. Investors know how much they pay for other management and research costs, because the management fee is disclosed in the

prospectus. However, they cannot gain similar insight into the costs of research associated with the soft-dollar component of commissions. Since the single best way to increase returns is to reduce costs, and since fund managers are less likely to focus on or be able to control opaque costs compared with explicit costs, this deficiency could harm investors by lowering their returns.

Nonetheless, undisclosed soft-dollar payments present a conflict of interest. For example, firms have an incentive to engage in more trading than they otherwise would, as they attempt to hit specific trade volume to receive research payments. In addition, having soft dollars outside of a stated expense ratio means there is less discipline about spending additional soft dollars. In fact, MiFID II changes have spurred firms to cut their spending on outside research. The current system incentivizes fund managers to move research costs out of the expense ratio and into soft dollars.

As financial institutions "unbundle" fees for all kinds of services, the additional transparency for investors means they are better able to assess whether the costs of services justify the fees; evidence from the EU suggests MiFID II has reduced costs for investors there. According to a recent Financial Conduct Authority review, most mutual funds have not passed on the costs of research previously included in soft-dollar payments to their customers. Further, there appear to have been savings on the costs of research as asset managers gain insight into their specific costs.[1]

Enhancing the disclosure of research costs would help investors understand the costs they pay for research and reduce the costs of disharmonized standards across jurisdictions.

The SEC should harmonize rules to facilitate MiFID II compliance and add additional transparency

Under the interpretive release on Section 28e of the Exchange Act in 2006, the SEC has permitted money managers to pay brokers for a variety of services including, but not limited to, traditional research reports analyzing the performance of a particular company or stock, discussions with research analysts, meetings with corporate executives to obtain oral reports on the performance of a company, and software that provides analyses of securities.[2] Unfortunately, however, the SEC did not require money managers to disclose the exact amounts of these fees, what they were being utilized for, and how they affected the returns to end-investors.

Given the implementation of MiFID II and its impact on the disclosure of soft dollars for money managers operating in Europe, the SEC appropriately took a temporary step with the no-action letters that helped ensure broker-dealers and asset managers could comply with MiFID II in the short term; however, this approach could lead to some unintended outcomes in the long term. For example, as commenters have pointed out, the no-action letters may encourage asset

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[1] See https://www.fca.org.uk/news/speeches/andrew-bailey-keynote-speech-mifid-ii-european-independent-research-providers-association

[2] Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934 at 28, July 18, 2006 https://www.sec.gov/rules/interp/2006/34-54165.pdf "SEC Interpretive Release."

managers to use commissions from non-EU clients to pay for research, perhaps worsening any existing conflicts that soft-dollar commissions create. Further, MiFID II presents an opportunity for the SEC to revisit and clarify soft-dollar regulations in the context of modern arrangements.

To address the inequity between U.S. and EU clients, we recommend that the SEC 1) create a safe harbor from IA registration for broker-dealers to disaggregate research costs from execution costs, and 2) require U.S.-based mutual funds to disclose soft-dollar payments for research in the statement of additional information.

This requirement, imposed on mutual funds, will naturally drive the market to demand more transparency from broker-dealers. Creating a safe harbor for broker-dealers from IA registration who disaggregate research costs for asset managers would harmonize the U.S. system with MiFID II, and allow asset managers with clients in the EU to more easily comply with the European Directive when they must. The SEC could craft this safe harbor narrowly under its statutory authority, under Section 202(a)(11) of the Investment Advisers Act, to allow broker-dealer research that is not personalized to be included within activities that are "solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."[3]

The SEC should not adopt some of the more controversial and complicated parts of MiFID II, such as the research payment accounts, which might not translate well in the U.S. Furthermore, it should support a long-overdue increase in transparency in the U.S. fund market, which is our recommendation relating to mutual fund disclosures. Similar standards would also reduce costs to U.S. investors due to the efficiency of having one set of rules.

Requiring mutual funds to disclose the cost of research received from broker-dealers as a percentage of assets under management would help investors understand how their fund spends their money on research. We would expect such disclosures to help advisors, ordinary mutual fund investors, and asset managers better assess the value of this research, and it might lead to some of these costs declining as they become easier to scrutinize.

We thank the Commission for the opportunity to comment on MiFID II's Research Provisions. Should you wish to discuss any of the comments in this letter, please do not hesitate to contact any of us as indicated below:

Russ Kinnel at [redacted] or [redacted].
Aron Szapiro at [redacted] or [redacted].
Jasmin Sethi at [redacted] or [redacted].

[3] Investment Advisers Act of 1940 Section 202(a)(11)(C).

Sincerely,

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