



May 2, 2019

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

Re: Markets in Financial Instruments Directive II (MiFID II) Research Rules

Dear Chairman Clayton:

The American Securities Association (ASA)<sup>1</sup>, representing our nation's Main Street and regional financial services companies, appreciates the work of the Securities and Exchange Commission (SEC or Commission) in helping market participants navigate the cross-border complexities of the European Union's Market in Financial Instruments Directive II (MiFID II). In particular, the ASA supported the issuance of a no-action letter (SIFMA Letter) in October 2017 that allows brokers to receive "hard dollar" payments from money managers for research.<sup>2</sup> However, the relief provided under the SIFMA Letter is only temporary, and brokers will be left in regulatory limbo when it expires in July 2020.

While the ASA does not support a U.S. mandate for the full unbundling of research and trading costs as envisioned under MiFID II, we believe that the SEC should codify, by rulemaking, the *ability* of broker-dealers to receive hard dollar payments for research from institutional investors. We believe that this can be achieved by the SEC using its broad exemptive authority under the Investment Advisers Act of 1940 (Advisers Act) to provide broker-dealers with a limited exemption from registration as an Investor Adviser to the extent they receive hard dollar payments for research from any institutional investor (U.S. or Non-U.S.). This would ease cross-border compliance issues arising from MiFID II, and simply make permanent the policy outlined by Division of Investment Management staff in the SIFMA Letter without the uncertainty associated with no-action relief.

Importantly, this will also allow the market to continue to evolve and afford asset managers the choice of whether to choose a bundled or unbundled research and trading solution. Small and mid-size asset managers may choose not to unbundle, while larger firms may adopt an opposite

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<sup>1</sup> The ASA is a trade association that represents the retail and institutional capital markets interests of regional financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans how to create and preserve wealth. The ASA's mission is to promote trust and confidence among investors and support efficient and competitively balanced capital markets that advance financial independence, stimulate job creation, and increase prosperity. The ASA has a geographically diverse membership base that spans the Heartland, Southwest, Southeast, Atlantic, and Pacific Northwest regions of the United States. [www.americansecurities.org](http://www.americansecurities.org)

<sup>2</sup> Response of the Division of Investment Management Chief Counsel to the Securities Industry and Financial Markets Association <https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm>

policy. Our view is that each company in the asset management industry should decide what is appropriate for their business model.

## Background

The ASA remains concerned about the well-documented decline in research coverage of U.S. equities – particularly small capitalization companies - over the last two decades. A 2017 report estimated that 61% of U.S. companies with less than a \$100 million market capitalization had no research coverage at all.<sup>3</sup> The SEC’s Investor Advisory Committee has also received testimony<sup>4</sup> regarding the decline in research coverage and its impact upon capital formation and the ability of companies to successfully complete an IPO. The Global Research Analyst Settlement of 2003, lack of secondary market liquidity in small cap stocks, and uncertainty surrounding implementation of certain provisions of the 2012 Jumpstart our Business Startups (JOBS) Act have all contributed to a decline in coverage. The ASA has in the past called for the SEC to conduct a holistic review of all these factors, and to recommend policy solutions that will help increase analyst coverage of small public companies.<sup>5</sup>

MiFID II – which went into effect in January 2018 - presents an altogether different and more complex challenge for broker-dealers in the United States to provide research to money managers. While payments for research have historically been bundled with trading costs, MiFID II requires the unbundling of these costs so that money managers must pay brokers directly for research. Putting aside whether it is appropriate and good policy for regulators to mandate how and under what circumstances market participants must pay for a product they want, MiFID II fundamentally alters the economics of research and will make it more difficult for money managers to receive sound research on a global basis.

Since the time of MiFID’s II implementation in Europe, there has been a steep decline in the number of research analysts employed as well as the number of companies covered. There has also been a trend towards coverage of larger, more established companies at the expense of smaller ones, which further exacerbates the difficulties that small companies have in accessing the capital markets.<sup>6</sup> In addition to depriving money managers of valuable research, the continued decline of company-specific information in the marketplace can further accelerate the trend toward automated and passive investment strategies. This ultimately results in a further lack of choice for both retail and institutional investors and demonstrates how well-intentioned regulatory efforts can often lead to deleterious outcomes.

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<sup>3</sup> CapitalIQ as of June 9, 2017

<sup>4</sup> Presentation of Cowen & Co. CEO Jeffrey Solomon before Investor Advisory Committee. June 22, 2017, available at <https://www.sec.gov/spotlight/investor-advisory-committee-2012/jeffrey-solomon-presentation.pdf>

<sup>5</sup> Joint organization report: Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public, available at [https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/IPO-Report\\_EXPANDING-THE-ON-RAMP.pdf](https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/IPO-Report_EXPANDING-THE-ON-RAMP.pdf)

<sup>6</sup> See e.g. Research Analysts’ Existential Crisis Enters MiFID II Era (Bloomberg) January 3, 2019, available at <https://www.bloomberg.com/news/articles/2019-01-03/the-research-analyst-s-existential-crisis-enters-mifid-ii-era>; Why MiFID II Isn’t Working as Intended and Investors are Losing as a Result (Melius Research) December 6, 2018, available at <http://www.integrity-research.com/mifid-ii-isnt-working-intended-investors-losing-result/>

In addition to decreasing choices for retail and institutional investors, recent research suggests that since MiFID II's implementation, funds in Europe that are subject to these new rules are actually underperforming their U.S. counterparts that are not unbundling.<sup>7</sup> This new data demonstrates that the costs imposed on fund shareholders by a lack of information will likely dwarf any benefits that come from MiFID's II research provisions.

### **Cross-border implications of MiFID II**

While the research provisions of MiFID II ostensibly apply only to institutions based in the European Union (or the EU affiliates of institutions based in other countries), their consequences extend far beyond European borders. For example, a U.S. money manager which operates on a global scale and has EU-based clients may be unwilling to pay for research from a U.S.-based broker dealer if that research could possibly be used to the benefit of their EU clients. The money manager would likely determine that they must follow the MiFID protocols in order to obtain such research, notwithstanding the fact that the arrangement could occur entirely within U.S. borders.

This presents a conundrum for U.S. broker-dealers: In order to comply with the MiFID directive money managers must pay brokers in hard dollars for research. However, brokers have historically been required to register under the Advisers Act in such a scenario. The SEC was correct to issue the SIFMA Letter that temporarily allows for the receipt of hard dollars by brokers, but the issue will arise again once the no-action period expires next year.

### **A permanent solution for broker-dealers and money managers**

Given the limited ability of the SEC to influence U.S. impact over a European Union directive (and given that MiFID II is unlikely to be repealed or significantly amended any time soon) we believe that the proper course of action for the SEC is to make permanent – through a notice and comment rulemaking – the ability of brokers to receive hard dollar payments for research without having to register as investment advisers. Without such relief, most broker-dealers will choose not to register under the Advisers Act due to the high cost on ongoing compliance, and the likelihood that any income generated from research would not outweigh the costs of registration and the additional challenges of complying with the fiduciary standards under the Advisers Act.

While hard dollars would not necessarily always be the preferred or required method of payment for research within U.S. borders, such an action by the SEC would allow brokers to provide research under circumstances where MiFID II may apply or where non-EU customers may ask to pay brokers hard dollars for research. Put simply, it would grant institutional market participants more flexibility and choice to determine payment arrangements for research. Absent this

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<sup>7</sup> Evercore - The Most Self-Serving Research Note Ever? The Unintended Consequences of MiFID II: P&L Payers Underperformed in 2018 (April 26, 2019).



certainty, it is likely that the United States will continue to see a drastic decline in research coverage of public companies – an outcome that is not good for investors or the economy as a whole.

We respectfully urge the SEC to move forward on a rulemaking that will provide much-needed clarity for brokers and money managers, and we reiterate our call for a holistic review of the equity research market to explore new ways for more companies can gain research coverage.

We look forward to working with you on this issue going forward.

Sincerely,

Christopher A. Iacovella  
Chief Executive Officer  
American Securities Association