Council of Institutional Investors®
The voice of corporate governance

Via E-Mail

January 31, 2019

The Honorable Jay Clayton
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: MiFID II Research Provisions

Dear Mr. Chairman:

I am writing on behalf of the Council of Institutional Investors (CII) in response to the staff of the Securities and Exchange Commission's (SEC or Commission) solicitation on how the European Union Markets in Financial Instruments Directive's (MiFID II) research provisions are affecting investors and others.[1]

CII is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management exceeding $4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than $25 trillion in assets under management.[2]

We wish to express gratitude for your responsiveness to our September 2017 written request that any no-action letter to be issued in response to MiFID II "be temporary in nature and be . . . followed by Commission action that provides for a public due process, including the solicitation of views by investors" (September Letter).[3] Consistent with that request, in October 2017 the SEC's Division of Investment Management issued a temporary no-action letter to the Securities Industry and Financial Markets Association (SIFMA Letter).[4]

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[1] Press Release, U.S. Securities and Exchange Commission, Staff Encourages Continued Engagement on Impact of MiFID II Research Provisions (Dec. 21, 2018), https://www.sec.gov/news/press-release/2018-301.
[2] For more information about the Council of Institutional Investors ("CII"), including its board and members, please visit CII's website at http://www.cii.org.
[3] Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to The Honorable Jay Clayton, Chairman, Securities and Exchange Commission (Sept. 22, 2017), https://www.cii.org/files/issues_and_advocacy/correspondence/2017/Sept_%2022%202017%20SEC%20Letter%20(final).pdf.
[4] Securities Industry and Financial Markets Association, SEC Staff No-Action Letter (pub. avail. Oct. 26, 2017), https://www.sec.gov/divisions/investmentess/noaction/2017/sifma-102617-202a.htm.

The SIFMA Letter offered narrow relief, granting temporary no-action assurance with regard to the Investment Advisers Act of 1940 to broker-dealers that receive payments in "hard dollars" or through MiFID-government research payment accounts from MiFID-affected clients.[5] U.S. investors are not subject to MiFID II, and therefore are excluded from this relief.

Ideally, we would prefer SEC action to grant no-action relief that would cover all investors, regardless of status under MiFID II. In essence, current policy permits broker-dealers to force the bundling of research with execution in non-MiFID II jurisdictions. We believe that the lack of price transparency fostered by bundling is harmful to the interests of CII members and fund beneficiaries.

However, we understand that it may not be possible for the SEC to provide no-action relief to all investors.[6] In that context, we ask the SEC to rescind the SIFMA Letter, for the reasons discussed below.

<u>The SIFMA Letter</u>

We believe the SIFMA Letter has harmful effects on U.S. retirees and workers who are the primary beneficiaries of CII member funds. Specifically, the SIFMA Letter permits a U.S. broker-dealer to provide research services to an investment manager that is required by MiFID II, either directly or by contractual obligation, to pay for the research services by using the manager's own money. Thus, the SIFMA Letter relieves a broker-dealer from having to register as an investment adviser if it takes hard dollar payments as a result of its customers' compliance with MiFID II (or equivalent contractual obligations), but does not if the same exact research is purchased by a customer that is out-of-scope of MiFID II. As a result, the SIFMA Letter creates an incentive for some global investment managers to pay for research using client commissions of non-EU clients or with respect to accounts not managed within the EU.[7]

As one example, we are aware that during 2018 one of our public pension plan members 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, the 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 were executed at lower "execution-only" commission rates with no offsetting hard dollar expenditure from the manager. Consequently, our member cross subsidized this manager's European clients, which benefited from the same research but do not contribute to the

[5] *See id.* ("we would not recommend enforcement action to the SEC 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").
[6] If the Securities and Exchange Commission (SEC) concludes the agency does not have the statutory authority to permit U.S. investment managers to unbundle their pricing, then the SEC should consider requesting such authority from the Congress.
[7] *See, e.g.,* Benjamin Bain, Wall Street Braces for MiFID II-Style Rules Descending on the U.S., Bloomberg, Jan. 23, 2019 (reporting that one example of an exception to the practice of global investment managers paying for research using client commissions of non-EU clients is the Capital Group who recently indicated "that it would reimburse clients for the third party research it uses after 'having carefully assessed the global regulatory environment and market conditions'"), https://www.bloomberg.com/news/articles/2019-01-23/wall-street-braces-for-mifid-style-rules-descending-on-the-u-s.

manager's research commission budget. This arrangement clearly puts the beneficiaries of our U.S. pension plan members and other U.S. "main street" investors at an unnecessary disadvantage to European investors.[8]

More broadly, by inhibiting the ability of U.S. institutional investors to be able to shop and pay for research and trading services, the SIFMA Letter continues to protect price opacity that allows U.S. broker-dealers to overcharge for research and trade execution.[9] In short, the SIFMA Letter acts as a "firewall" that insulates U.S. broker-dealers from the MiFID II requirement to unbundle commissions.[10] CII and our members have long been concerned with the lack of price transparency and accountability in the provision and payment for investment research and trade execution that is inherent in the bundled system.[11]

<u>CII Policies</u>

As we indicated on our September Letter,[12] since 1998 CII membership approved policies have included the following principles:

> **Guiding Principles for Trading Practices, Commission Levels, Soft Dollars and Commission Recapture**
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> The most important voice in discussions of soft dollars, commission levels and directed brokerage belongs to us, as institutional investors. Commissions are an asset of the plan, and as plan sponsors and trustees it is our right and responsibility to decide how they are managed. . . . We . . . have the broader duty to communicate the interests and desires of the institutional investor community to regulators, to the public and to the industry regarding trading practices and commissions.
>
> Like any other expense of the plan, trading costs need to be managed to minimize the cost and ensure that maximum value is received. But current brokerage industry practices of bundled pricing for services make it difficult to break out the exact costs of services (for trade execution, research or other things), may be antithetical to the fiduciary obligation of obtaining best execution, and hold too much potential for conflicts of interest and abuses.
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> We support and urge full unbundling of pricing for investment management,

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[8] *Id.* (reporting that a "concern among state pension boards is that they are paying for analysis that isn't benefiting them").
[9] *Id.* ("the EU's new rules have prompted U.S. pension plans . . . to increasingly question whether combining costs for securities trading and analysis leads to price opacity that lets Wall Street overcharge for research").
[10] *Id.* (reporting that the Securities Industry and Financial Markets Association no-action letter "was seen as a firewall that insulated Wall Street from MiFID II").
[11] *See* CII, Policies on Other Issues, **Guiding Principles for Trading Practices, Commission Levels, Soft Dollars and Commission Recapture** (Mar. 31, 1998), http://www.cii.org/policies_other_issues#principles_trading_commission_softdollar.
[12] Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to The Honorable Jay Clayton, Chairman, Securities and Exchange Commission at 2.

> brokerage and research services, so that institutional investors can purchase and budget for these services as they do any other expense of the plan. . . . .[13]

Our policy is based on the view that separating the decisions for where to trade and from where to buy research will foster better price-discovery and more efficient allocation of resources related to research and trading, benefitting investors and asset owners. We are pleased that even the SIFMA Asset Management Group appears, at least in part, to have adopted our view.[14]

While we understand concerns that the unbundling of broker-dealer commissions might adversely affect research availability for the smallest public companies,[15] we have yet to see compelling evidence of that effect. On the other hand, we have seen significant, non-transparent costs to investors for decades as a result of bundling.

We believe the SEC should embrace transparency and market forces for determining the value of research. In the long-term, we believe transparency and market forces will facilitate higher quality independent research that will enhance market efficiency, including higher quality independent research on smaller issuers.[16]

CII's Recommendation

In keeping with the intent of our policies, and in the absence of broader relief for investors from bundling of research with trade execution, CII respectfully recommends that the SEC rescind the SIFMA Letter as soon as practicable. As indicated, we believe the SIFMA Letter protects price opacity that allows broker-dealers to overcharge for research and trade execution that has harmful effects on the beneficiaries of our member funds.

We also respectfully recommend that the rescission of the SIFMA Letter be accompanied by an SEC statement. The statement should indicate that enforcement actions against unregistered broker-dealer research providers for allowing U.S. institutional investors and their investment managers to pay for research separate from client commissions will be pursued *only* to the extent that the SEC concludes that such actions would be in the best the interests of U.S. investors and the capital markets generally.

[13] **Guiding Principles for Trading Practices, Commission Levels, Soft Dollars and Commission Recapture**.

[14] *See* Letter from Timothy W. Cameron. Esq., Asset Management Group – Head, Securities Industry and Financial Markets Association et al. to The Honorable Walter Jay Clayton, Chairman, U.S. Securities and Exchange Commission 1 (Dec. 14, 2018) ("investors would be best served if asset managers were able to choose a payment arrangement for investment research that makes sense based on the individual circumstances"), https://www.sifma.org/resources/submissions/timing-and-substantive-concerns-related-to-no-action-relief-for-dealing-commissions/.

[15] *See, e.g.,* Benjamin Bain ("One quandary for the SEC: analysts might have even less of an incentive than they do now to follow the smallest public companies if strategists' research isn't supported by trading fees"); *see also* Staff Encourages Continued Engagement on Impact of MiFID II Research Provisions ('"it is important to have data and other information about how MiFID II's research provisions are affecting . . . small . . . issuers, including whether research availability has been adversely affected'").

[16] *See, e.g.,* Bloomberg, Research Analysts' Lives Changing in MiFID II Era, P&I, Jan. 3, 2019 ("For an industry that thrives on dissecting numbers and predicting winners and losers, it makes sense that its value should now be determined by market forces."), https://www.pionline.com/article/20190103/ONLINE/190109969/research-analysts-livesCII-changing-in-mifid-ii-era.

Thank you for consideration of our views. If we can answer any questions or provide additional information with respect to this letter, please do not hesitate to contact me at 202.822.0800 or jeff@cii.org.

Sincerely,

Jeff Mahoney

Jeffrey P. Mahoney
General Counsel

cc: The Honorable Commissioner Robert J. Jackson, Jr., U.S. Securities and Exchange Commission

The Honorable Commissioner Hester M. Peirce, U.S. Securities and Exchange Commission

The Honorable Commissioner Elad L. Roisman, U.S. Securities and Exchange Commission

Ms. Dalia Blass, Esq., Director, Division of Investment Management,
U.S. Securities and Exchange Commission

Mr. Brett Redfearn, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission