



CFA Institute

THE FUTURE OF RESEARCH IN THE US AFTER MIFID II

Resolving EU/US Disparities





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Executive Summary

In a 26 June 2019 letter (the Letter) to Jay Clayton, Chair of the US Securities and Exchange Commission (Commission or SEC), CFA Institute, together with the Healthy Markets Association (Healthy Markets) and the Council of Institutional Investors (collectively, the Coalition), conveyed two recommendations to address issues raised by the Markets in Financial Instruments Directive II (MiFID II) for US-based broker/dealers and asset managers. The Coalition recommended that the SEC revise guidance under Section 28(e) of the Securities Exchange Act of 1934 (the Exchange Act) as follows:

1. require investment managers and advisers who seek to rely on the Section 28(e) safe harbor to disclose amounts paid for research from client assets; and
2. require investment managers and advisers who seek to rely on the Section 28(e) safe harbor to adopt and implement procedures to ensure benefits of research go to the asset owners who pay for it.

Background

The Letter was not the first time CFA Institute had addressed the use of soft dollars by asset managers. In 1998, a task force of volunteer members from the organization, then called the Association for Investment Management and Research, had recognized the ethical problems associated with asset managers' use of assets derived from soft dollars and bundled brokerage arrangements (benefits collectively referred to as Client Brokerage) and had drafted standards to address those concerns. Now known as the CFA Institute *Soft Dollar Standards* (the Standards), the project educated both members and the broader industry about the appropriate ethical use of this intangible asset. The Standards' guiding principle was that any value an asset manager derives from trading investment assets on behalf of a client ultimately belongs to that client and use of that value must be to the benefit of that client. CFA Institute later applied these principles in responses to regulatory consultations in the United States, the United Kingdom, and the European Union over the next 20 years.

MiFID II took regulation of these assets much further in fundamental ways. In particular, the rules stipulated that asset managers must either pay cash to purchase investment research or create prebudgeted commission-sharing arrangements to pay for research over the course of a year. By prohibiting the use of soft commissions and bundled brokerage to pay for investment research and other products and services, however, the rules created

a stark conflict with long-established US rules, which (a) permit asset managers to use Client Brokerage to pay for research and other services, and (b) prohibit broker/dealers from accepting cash for investment research unless they register as investment advisers.

Beyond these inter-Atlantic conflicts, MiFID II also is causing tectonic shifts in the competitive balance between asset managers, brokers, and research providers. Sophisticated asset owners, for example, have long called for disclosure of research costs paid through Client Brokerage, but with little success. Sensing the change in competitive balance from MiFID II, however, US asset owners are not only demanding disclosure of how their hired asset managers are using Client Brokerage, but in some cases demanding they not be asked to pay for research at all. Globally, too, asset managers are adjusting what they will pay for broker research as part of their broker selection and trading decisions.¹ At the other end of the spectrum, many research providers are struggling to adapt to increased price transparency and increased scrutiny of research and trading costs.

Although ostensibly applicable only to investment firms in the 28 EU member states, MiFID II has created important and foundational changes in the global research market. That conflict ultimately required the no-action relief for brokers and asset managers that is the concern of this report.

Recommendations

To address the conflicts and changes MiFID II has created for US-based broker/dealers and asset managers, we recommend the following regulatory and industry responses:

- (1) the SEC should interpret Section 202(a)(11) to permit broker/dealers to accept cash as payment for investment research without having to register as investment advisers;
- (2) the SEC should require asset managers to disclose to their asset-owner clients the cost of research purchased on their behalf through Client Brokerage arrangements;
- (3) asset managers should adopt policies and procedures to ensure that the research purchased from Client Brokerage arrangements, over time, benefits the asset owners whose trading commissions paid for the research;
- (4) asset managers should adopt and implement policies and procedures that move toward separating research procurement decisions from decisions about with whom and how to trade;

¹ See, for example, CFA Institute, US Payment for Research and MiFID II Survey (reflecting that 49% of respondents “never” factor in research when selecting a broker with which to trade) (CFA Institute *2019 US Research Survey*, <https://www.cfainstitute.org/research/survey-reports/us-payment-research-mifid-ii-2019-survey>).

- (5) the SEC should consider investor outcomes rather than specific costs, when interpreting whether an investment manager or adviser is achieving best execution for its clients; and
- (6) the SEC should revise its interpretations of Section 28(e) and such other rules and guidance as is necessary and appropriate to effectuate these recommended reforms.

This report

- explores the history of research payment rules in the United States,
- outlines the global changes in research procurement and payment practices,
- explains why these changes are happening now, and
- offers regulatory recommendations to address these changes.

CFA Institute appreciates the assistance in the preparation of this report from Healthy Markets Association, an investor-focused, not-for-profit coalition of institutional investors and other investment firms and organizations serving the investment markets. Healthy Markets reviewed and assessed the existing legal, regulatory, and business structures for the production and distribution of investment research in both the United States and the European Union at the time of publication. This published report is the property of CFA Institute and the findings, opinions, and recommendations stated herein are official positions of CFA Institute.

Background on Regulatory Requirements Regarding Payments for Research in the United States

Research procurement and payment practices are often tied to an asset manager's best-execution practices. For decades, broker/dealers were a significant source of investment research and specialized analysis for asset managers. Many managers used the assets of their clients to pay for this research as part of a bundled commission rate.²

In the United States, this longstanding practice is explicitly authorized by Section 28(e) of the Exchange Act. Adopted in 1975, Section 28(e) protects investment advisers from claims of breaching their fiduciary duties by paying increased commission rates to obtain investment research.³ Conversely, as the SEC has long recognized,

[u]se of client commissions to pay for research and brokerage services presents money managers with significant conflicts of interest, and may give incentives for managers to disregard their best execution obligations when directing orders to obtain client commission services as well as to trade client securities inappropriately in order to earn credits for client commission services.⁴

² See Letter from Michael C. Gitlin et al., Capital Research and Management Company, to Hon. Jay Clayton, SEC, at 2 (11 February 2019). <https://www.sec.gov/comments/mifidii/cll5-4919397-178352.pdf> (February 2019 Capital Group Letter).

³ Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78bb(e): "No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to June 4, 1975, solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion."

⁴ *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, SEC, Exch. Act Rel. No. 54165, at 3 (18 July 2006). <https://www.sec.gov/rules/interp/2006/34-54165.pdf> (2006 Guidance).

Unlike broker/dealers' best-execution obligations, which are clearly defined by Financial Industry Regulatory Authority (FINRA) Rules,⁵ the contours of investment advisers' obligations are more loosely defined by a combination of interrelated rules, SEC guidance, and case law.

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., commissions).”⁶ Unlike in Europe,⁷ SEC rules and guidance do not specify what those factors must include. That said, these factors often include price, costs, speed of execution, likelihood of execution, and settlement as well as order size, nature of specific trades, and anything else the firm deems relevant, including the provision of investment research.

In addition, the SEC requires statements of additional information to include a description of the fund's brokerage allocation and other practices that may affect best execution, including commissions details and broker/selection practices.⁸ Investment advisers must detail conflicts of interest in their trading practices, including research paid for with client commissions.⁹

⁵ FINRA, *Rule 5310: Best Execution and Interpositioning*. Several other FINRA rules supplement this best-execution rule, most notably Rule 2121, which governs commission rates and fees, including markups and markdowns. FINRA Rule 2121, *Fair Prices and Commissions*.

⁶ Item 12 of Form ADV Part 2A.

⁷ For example, under MiFID II, asset managers 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. Additionally, under MiFID II, covered asset managers must also publicly disclose their best execution policies. European Securities and Markets Authority, MiFID II, Article 27, “Obligation to Execute Orders on Terms Most Favourable to the Client.” <https://www.esma.europa.eu/databases-library/interactive-single-rulebook/clone-mifid-ii/article-27-0>.

⁸ See US SEC, Form N-1A, Item 21. <https://www.sec.gov/files/formn-1a.pdf>. See, for example, TIAA-CREF Funds, Statement of Additional Information (1 March 2019). <http://connect.rightprospectus.com/TIAA/TADF/87245M269/S>. “In evaluating best execution for transactions, Advisors considers a number of factors, including, without limitation, the following: best price; the nature of the security being traded; the nature and character of the markets for the security to be purchased or sold; the likely market impact of the transaction based on the nature of the transaction; the skill of the executing broker; the liquidity being provided by the broker; the broker-dealer's settlement and clearance capability; the reputation and financial condition of the broker-dealer; the costs of processing information; and the nature of price discovery in different markets.”

⁹ See Lori Richards, Director, Office of Compliance Inspections and Examinations, SEC, “Fiduciary Duty: Return to First Principles,” speech before the Eighth Annual Investment Adviser Compliance Summit (27 February 2006). <https://www.sec.gov/news/speech/spch022706lar.htm>. See also, CFA Institute, *Trade Management Guidelines* (November 2002). <https://www.cfainstitute.org/-/media/documents/code/other-codes-standards/trade-management-guidelines.ashx>.

On 11 July 2018, the SEC’s Office of Compliance, Inspections, and Examinations issued a Risk Alert outlining the agency staff’s expectations regarding investment advisers’ best-execution and research practices.¹⁰ Among other “deficiencies” identified in the Risk Alert by the examinations staff through its review of more than 1,500 investment advisers, the SEC found the following:

- “Advisers that did not appear to adequately disclose the use of soft dollar arrangements.”¹¹
- “Advisers that did not disclose that certain clients may bear more of the cost of soft dollar arrangements than other clients.”¹²
- “Advisers that did not appear to provide adequate or accurate disclosure regarding products and services acquired with soft dollars that did not qualify as eligible broker-age and research services under the Section 28(e) safe harbor.”¹³
- Advisers that did not allocate soft-dollar expenses in accordance with their policies.¹⁴

Ultimately, although the SEC has somewhat illustrated the contours of Section 28(e) with regulatory guidance¹⁵ and enforcement actions,¹⁶ it generally has provided wide latitude for firm compliance. For example, the SEC has not traditionally required investment advisers to disclose the research costs they pass through to their asset-owner clients. Nor has the SEC mandated that research purchased with asset owners’ commissions benefit those same asset owners whose assets are being used.¹⁷

¹⁰ SEC, *Risk Alert: Compliance Issues Related to Best Execution by Investment Advisers* (11 July 2018). <https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf> (2018 Risk Alert).

¹¹ 2018 Risk Alert, at 3.

¹² 2018 Risk Alert, at 3.

¹³ 2018 Risk Alert, at 3.

¹⁴ 2018 Risk Alert, at 4.

¹⁵ See the *2006 Guidance*; see also SEC Interpretation: Commission Guidance on the Scope of Section 28(e) of the Exchange Act, SEC, Exch. Act Rel. No. 34-45194 (27 December 2001). <https://www.sec.gov/rules/interp/34-45194.htm> (2001 Guidance).

¹⁶ See, for example, *In the Matter of Dawson-Samberg Capital Management, Inc. and Judith A. Mack*, Advisers Act Rel. No. 1889, 54 SEC 786 (3 August 2000), regarding personal travel and other expenses. <https://www.sec.gov/litigation/admin/ia-1889.htm>. See also *In the Matter of Marvin & Palmer Associates, Inc., et al.*, Advisers Act Rel. No. 1841, 70 SEC Docket 1643 (30 September 1999). <https://www.sec.gov/litigation/admin/ia-1841.htm>.

¹⁷ See, for example, TIAA-CREF Funds, Statement of Additional Information, at 86, acknowledging that “research services may not always be utilized in connection with the Funds or other client Accounts that may have provided the commission or a portion of the commission paid to the broker providing the services.”

Global Research Payments Practices Are Changing

Although regulators globally, including in the United States, have not materially updated research payment rules in decades, European regulators began the process of considering groundbreaking new rules on research practices beginning in the aftermath of the global financial crisis, with the rules relating to soft commissions and investment research becoming effective in January 2018. These rules, adopted as part of MiFID II¹⁸ and the separate Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs Regulation), have dramatically altered business practices around the globe.¹⁹

Asset managers with MiFID II-covered accounts are required to pay for research using Research Payment Accounts, their own hard dollars, or both. Additionally, among other expectations, asset managers must explicitly quantify the value of research they consume, decouple the amount paid for research from the volume they trade, prepare a budget and disclose to customers any research expenses paid using client assets,²⁰ and detail how a client who pays for research actually benefits from such research.

In response, most asset managers that are covered by these MiFID II rules have responded by absorbing the costs for research for covered accounts out of their own funds, as opposed to using their asset owners' commissions.²¹ Transparency into research costs has increased and overall research expenses have decreased.²²

¹⁸ Directive 2014/65, of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments and Amending Commission Directive 2002/92 and Council Directive 2011/61, *Official Journal of the European Union* 57, L 173 (12 June 2014), 349. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2014:173:TOC>.

¹⁹ See, for example, EY, *MiFID II and PRIIPs Reporting Services for Asset Managers* (2018). [https://www.ey.com/Publication/vwLUAssets/MiFID_II_and_PRIIPs:_Reporting_Services_for_asset_managers/\\$File/MiFID%20II%20and%20PRIIPs%20-%20Reporting%20Services%20for%20asset%20managers.pdf](https://www.ey.com/Publication/vwLUAssets/MiFID_II_and_PRIIPs:_Reporting_Services_for_asset_managers/$File/MiFID%20II%20and%20PRIIPs%20-%20Reporting%20Services%20for%20asset%20managers.pdf).

²⁰ We understand that European regulators, as of July 2019, may be exploring further revisions to MiFID II that could include, among other things, permitting client commissions to be used provided adequate disclosures are made, but without needing to be disclosed and budgeted in advance.

²¹ Remarks of Andrew Bailey, Financial Conduct Authority (FCA), before the European Independent Research Providers Association (25 February 2019). <https://www.fca.org.uk/news/speeches/andrew-bailey-keynote-speech-mifid-ii-european-independent-research-providers-association>. “Most notable has been the shift by a vast majority of traditional asset managers to fund research from their own revenues—instead of using their clients’ funds.”

²² See, Paul Clarke and David Ricketts, “BlackRock Slashes Spending on Investment Research by 60%,” *Financial News* (18 February 2019). <https://www.fn.london.com/articles/blackrock-slashes-spending-on-investment-research-by-60-20190218>. Also see “MiFID II Forces Fund Managers into Sharp Research Cuts,” *Financial Times*. <https://www.ft.com/content/b22f7102-43af-11e8-803a-295c97e6fd0b> and “MiFID Cuts Research Income by 20 Percent, and There’s Worse to Come,” *Globalcustody.net* (1 November 2018). https://www.globalcustody.net/news/MiFID_cuts_research_income_by_20_percent_theres_worse_to_come_12573/.

[T]he new rules are having a positive impact on the accountability and discipline of the buy-side when procuring research, and on the cost of execution.

—Andrew Bailey, Chief Executive of the United Kingdom Financial Conduct Authority (February 2019)

These changes are already altering the global competitive landscape and have led to dramatic transformations of business practices. Many asset owners that generally are not covered by MiFID II (such as US pension funds) are nevertheless increasingly demanding MiFID II-like practices from their investment advisers through private contract. For example, it is increasingly common for asset owners to expect as a term in their Requests for Proposals and contracts with investment advisers that they not directly pay for research or that they pay only a predetermined amount.

Thus, European rules and competitive pressures have triggered the development and increasing adoption of practices such as the following:

- identifying and determining the explicit itemized values for executions and research, including developing and implementing policies and procedures to track and value research received through utilization;
- establishing research payment mechanisms that can comply with both MiFID II and Section 28(e) obligations;²³
- establishing research payment strategies that decouple the amount paid for research from the amount paid for trading execution and other services, including by setting research budgets in advance, on a portfolio or customer level, and, if commissions are used to pay for research, agreeing to either pay a preestablished amount for the research, or ensuring that executions with the provider thereafter may be at execution-only rates or will be reimbursed by the adviser;
- periodically evaluating trading decisions and adjusting routing decisions based upon increasingly sophisticated analyses; and

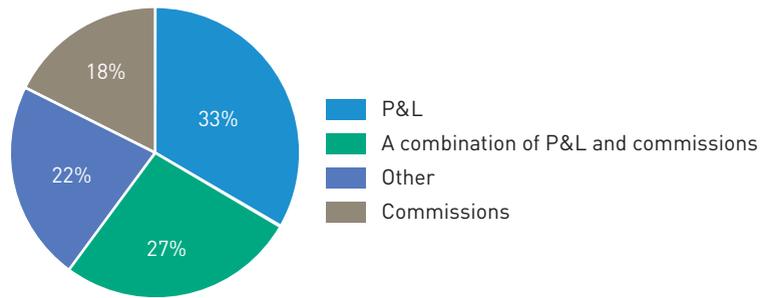
²³ Before the implementation of MiFID II and the PRIIPs Regulation, many investment advisers declared that they would no longer pass through research costs to their MiFID II-covered customers. See, for example, Chris Flood, “BlackRock to Foot Bill for External Research Under MiFID II,” *Financial Times* (14 September 2017). <https://www.ft.com/content/fb9e2552-9939-11e7-a652-cde3f882dd7b>. See also Jennifer Thompson, “T Rowe Price to Absorb MiFID II Research Costs,” *Financial Times* (21 August 2017). <https://www.ft.com/content/46fff37d-d422-34db-ab41-fb83258f5e4a>. T. Rowe Price has subsequently determined to absorb third-party research costs for all of its accounts around the world—not just for clients subject to MiFID II.

- revising their disclosures related to soft-dollar arrangements, broker selection, and best execution.²⁴

That said, US-based investment advisers report significant variability in their responses (or lack thereof) to these changes. For example, in a CFA Institute member survey conducted in March and April of 2019, 33% of respondents indicated that their firms paid for research using exclusively their own assets, and approximately half currently assign dollar values to consumed research (figure 1).²⁵

Although not every US investment adviser has materially altered how they value, consume, and pay for research in recent years, changes are underway. For example, some are opting to establish and use commission-sharing arrangements, whereas others have moved to entirely separate decisions about procurement and payment for research from decisions about trade execution. Some multinational managers have decided to pay directly for research on behalf of their European customers, while still using US clients' commissions

FIGURE 1. HOW DOES YOUR FIRM PAY FOR RESEARCH?



²⁴ Letter from Tyler Gellasch, Healthy Markets Association, to Hon. Jay Clayton, SEC, Health Markets Transparency & Trust (2 April 2018). <https://healthymarkets.org/wp-content/uploads/2018/05/04-02-18-HM-letter-Impact-on-Payments-for-Research.pdf> (Healthy Markets Letter).

²⁵ CFA Institute, *2019 US Research Survey*.



to pay for research.²⁶ Allocation of projected research costs to clients on a forward-looking basis already is occurring to some degree (much like a research payment account RPA). As of mid-2019, a handful of US-based investment advisers have determined to pay for third-party research costs using their own assets for all of their customers.²⁷

²⁶ See the February 2019 Capital Group Letter: “This has created an environment where many global asset managers have determined to pay for research for their clients in the European Union, but continue to have other investors, including those in the United States, pay for research through the use of equity trading commissions. It strikes us as an unworkable long-term solution to continue having only certain clients benefit from an investment manager’s willingness to bear the expense of research based on where the clients, or their investment manager, is located.” see also Chris Flood, “BlackRock to Foot Bill for External Research Under MiFID II.”

²⁷ Benjamin Bain, “Wall Street Braces for MiFID-Style Rules Descending on the U.S.,” *Bloomberg* (23 January 2019). <https://www.bloomberg.com/news/articles/2019-01-23/wall-street-braces-for-mifid-style-rules-descending-on-the-u-s>. Capital Group, T. Rowe Price, and Sands Capital Management had or were in process of implementing methods to pay for third-party research. Furthermore, because some research providers may not accept hard-dollar compensation for research, these firms may initially pay for the research using client commissions and then engage in complex and burdensome reimbursement processes.

A Market Ready for Change

Market participants, investor trade groups, standard setters (including CFA Institute), and regulators have called for reforms on research payment practices for years. Yet, until the adoption of new rules in Europe, changes had been slow. Now, with the implementation of new European rules, market participants and regulators around the world are rapidly revising their expectations about their rules and how to enforce them. These revisions are not simply a result of the rules changes but also of changes in competitive pressures.

Investors Have Long Sought Enhanced Transparency into Research Practices

For decades, investors and their advocates have sought to better understand how asset owners' commissions are used to pay for investment research. For example, CFA Institute adopted its original Standards in 1998 (amended in 2011) as a guide for members and investment managers on the appropriate use of client commissions.²⁸ The Standards explicitly recognize two fundamental principles about the benefits arising from the payment of commissions, referred to collectively as “brokerage:”

1. Brokerage is the property of the Client.
2. The Investment Manager has an ongoing duty to ensure the quality of transactions effected on behalf of its Client, including
 - a. seeking to obtain Best Execution,
 - b. minimizing transaction costs, and
 - c. using Client Brokerage to benefit Clients.²⁹

To implement these principles, the Standards seek to provide the following:

- full and fair disclosure of an investment manager's use of a client's brokerage;

²⁸ CFA Institute, *Soft Dollar Standards* (2011). <https://www.cfainstitute.org/-/media/documents/code/other-codes-standards/soft-dollar-standards-corrected-2011.ashx>.

²⁹ CFA Institute, *Soft Dollar Standards*, at 6.

- consistent presentation of information so that the client, broker, and other applicable parties can clearly understand an investment manager’s brokerage practices;
- uniform disclosure and recordkeeping to enable an investment manager’s clients to clearly understand how their investment managers are using clients’ brokerage; and
- high standards of ethical practices within the investment industry.³⁰

These obligations include, upon request by the adviser’s customer, providing an advisory customer with the total amount of commissions generated for that customer through soft-dollar arrangements, on a broker-by-broker basis.³¹

Likewise, in 1998, the Council of Institutional Investors (a trade group predominantly composed of pension funds, endowments, and foundations) instituted the following policy:

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.

We support and urge full unbundling of pricing for investment management, brokerage and research services, so that institutional investors can purchase and budget for these services as they do any other expense of the plan.³²

European Regulators Changed the Rules

The regulatory changes brought upon by MiFID II and PRIIPs resulted, in part, from an inquiry launched by the United Kingdom’s former markets regulator, the Financial Services Authority (FSA), more than a decade ago. During the course of its reviews of asset managers, the FSA found that “some firms no longer saw conflicts of interest as a

³⁰ CFA Institute, *Soft Dollar Standards*, at 2.

³¹ CFA Institute, *Soft Dollar Standards*, at 8.

³² Council of Institutional Investors, Policies on Other Issues, “Guiding Principles for Trading Practices, Commission Levels, Soft Dollars and Commission Recapture” (31 March 1998). http://www.cii.org/policies_other_issues#principles_trading_commission_softdollar.

key source of potential detriment to their customers” and “had relaxed controls” below what it believed were acceptable industry practices.³³

The regulator followed with two consultation papers of the issue,³⁴ and reported its findings in November 2012.³⁵ The FSA found many asset managers were violating its rules regarding “use of customers’ commissions and the fair allocation of trades between customers.”³⁶ The FSA further 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.*³⁷

Eighteen months later, after abolition of the FSA and creation of the Financial Conduct Authority (FCA) as conduct regulator, the FCA revised UK soft-commission rules to “ensure investment managers seek to control costs passed onto their customers with as much rigor as they pursue investment returns.”³⁸ In July 2014, the FCA released a discussion paper on asset managers’ use of commissions in the wake of the rules changes.³⁹

While changing its domestic rules, the FCA also worked with the European Commission to adopt significant reforms in MiFID II. Among other changes, MiFID II explicitly requires asset managers to pay for research using their own assets, specially dedicated

³³ Financial Services Authority (FSA), *Conflicts of Interest Between Asset Managers and Their Customers: Identifying and Mitigating the Risks*, at 4 (November 2012). <http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf>.

³⁴ See FSA, Consultation Paper 05/5 (CP 05/5), “Bundled Brokerage and Soft Commission Arrangements: Proposed Rules” (March 2005). https://webarchive.nationalarchives.gov.uk/20120303142324/http://www.fsa.gov.uk/pubs/cp/cp05_05.pdf. See also FSA, Consultation Paper 176 (CP 176), “Bundled Brokerage and Soft Commission Arrangements (April 2003). <https://webarchive.nationalarchives.gov.uk/20121119141247/http://www.fsa.gov.uk/pubs/cp/cp176.pdf>.

³⁵ See FSA, “Conflicts of Interest Between Asset Managers and Their Customers: Identifying and Mitigating the Risks” (Conflicts of Interest), (November 2012). <http://www.frostrb.com/perch/resources/conflicts-of-interestnov2012-2.pdf>.

³⁶ FSA, Conflicts of Interest.

³⁷ FCA, *Changes to the Use of Dealing Commission Rules: Feedback to CP13/17 and Final rules (PS14/7)*, at 6 (May 2014). <https://www.fca.org.uk/publication/policy/ps14-07.pdf>.

³⁸ FCA, PS 14/7, at 6.

³⁹ FCA, *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). <https://www.fca.org.uk/publication/discussion/dp14-03.pdf>.

RPA, or some combination of the two. Those changes came into effect on 3 January 2018. At the same time, PRIIPs requires asset managers to make concise key information disclosures (KIDs) about retail investment and insurance products including transaction costs. Those changes came into effect on 1 January 2018. Collectively, these rules have fundamentally altered the processes for obtaining, using, and paying for investment research in Europe.

US Regulators Have Yet to Adopt a Comprehensive Response to Changes in European Rules and Evolving Practices

The last significant guidance from the SEC regarding research payment and soft-dollar practices came in 2006.⁴⁰ Since then, spurred by MiFID II and the PRIIPs Regulation in Europe, practices around the world have changed significantly.

In advance of the European implementation of MiFID II in January 2018, Securities Industry and Financial Markets Association (SIFMA),⁴¹ SIFMA's Asset Management Group (AMG),⁴² and the Investment Company Institute (ICI)⁴³ each petitioned the SEC for “no-action relief” from US rules that appeared to create difficulties for firms seeking to comply with the new European research payment regime.

In October 2017, the SEC staff issued No-Action Letters to each, SIFMA,⁴⁴ SIFMA AMG,⁴⁵ and ICI⁴⁶ (collectively, the No-Action Letters), which provided that—

⁴⁰ See the 2006 Guidance. The 2006 Guidance describes what it sees as research and brokerage services, and the principles for broker/dealers' execution and research services that determine whether money managers can use the safe harbor.

⁴¹ Letter from Steve Stone, Morgan Lewis (on behalf of SIFMA) to Douglas Scheidt, SEC (17 October 2017). <https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a-incoming.pdf>.

⁴² Letter from Timothy W. Cameron and Lindsey Weber Keljo, SIFMA AMG, to Heather Seidel, SEC (25 October 2017). <https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf>.

⁴³ Letter from Dorothy Donohue, Investment Company Institute, to Douglas Scheidt, SEC (20 October 2017). <https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1-incoming.pdf>.

⁴⁴ Letter from Elizabeth Miller, SEC, to SIFMA (26 October 2017). <https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm> (SIFMA No-Action Letter).

⁴⁵ Letter from Heather Seidel, SEC, to Timothy Cameron and Lindsey Keljo, SIFMA AMG (26 October 2017). <https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf> (SIFMA AMG No-Action Letter). Note that the SIFMA letter to the SEC is attached below the SEC response in the file.

⁴⁶ Letter from Aaron Gilbride, SEC, to ICI (26 October 2017). <https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm> (ICI No-Action Letter).

1. broker/dealers, on a temporary basis, may receive research payments from money managers in hard dollars or from advisory clients' research payment accounts;
2. money managers may continue to aggregate orders for mutual funds and other clients; and
3. money managers may continue to rely on an existing safe harbor when paying broker/dealers for research and brokerage.⁴⁷

The No-Action Letters relieved brokers and investment advisers from some of the pragmatic challenges of reconciling the US and European research payment regimes.⁴⁸ For example, it allowed investment advisers to aggregate multiple customer orders onto a single trade ticket even though customers were paying different commission rates. This created the possibility for inclusion of a European customer with an execution-only rate and a US customer with a bundled rate.

The No-Action Letters did not receive uniform approval from other market participants, however. Several, together with a handful of trade associations, expressed concerns that the no-action relief may give rise to unintended consequences, including that it may:

- create the opportunity for, and potentially permit, investment advisers to shift research costs from European customers onto US asset owners;
- permit some research providers (i.e., broker/dealers) to force US asset owners (as opposed to investment advisers) to continue paying for research out of their returns;

⁴⁷ SEC, "SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions," press release (26 October 2017). <https://www.sec.gov/news/press-release/2017-200-0>.

⁴⁸ See SIFMA No-Action Letter, 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"; SIFMA AMG No-Action Letter, 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... and conforming to the requirements for RPAs in MiFID II, provided that all other applicable conditions of Section 28(e) are met"; and ICI No-Action Letter, granting assurances that SEC staff wouldn'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 the Letter from Karrie McMillan, SEC, to SMC Capital, Inc. (5 September 1995)). <https://www.sec.gov/divisions/investment/noaction/smccapital090595.htm>.

- compel some US-based investment adviser customers seeking research to direct order flow and executions to brokers supplying the research, even if the execution costs are higher or quality is lower than could otherwise be found; and
- systematically disadvantage smaller investment advisers and others who are more dependent on third-party research—both in their trading costs and overall returns for their underlying asset owners.⁴⁹

In part as a result of some of these concerns, the SIFMA No-Action Letter was limited to 30 months. If that letter expires as scheduled in July 2020, broker/dealer research providers who accept hard-dollar payments for research would have to register as investment advisers. Some market participants have expressed concerns with the impact on the global research markets if that letter expires without a replacement.⁵⁰ As of July 2019, it is unclear what, if anything, the SEC will do to address those concerns. Similarly, the SEC has not yet responded to concerns about the lack of transparency into costs for research that are passed through to asset owners.⁵¹

Key Issues Regarding Evolving Research Procurement and Payment Practices

Stripped of the legalese, Section 28(e) of the Exchange Act states that the SEC will not consider managers paying extra commissions from clients' accounts to buy research as a breach of their fiduciary duties to their clients' discretionary accounts. The advisers will have had to determine “in good faith” that the extra commissions were reasonable in comparison with the value of the research and execution received for each trade and in the overall handling of the accounts.

On the basis of these requirements, it is reasonable to assume that asset managers seeking to use client commissions to pay for research should consider five distinct sets of questions:

1. Are research costs paid by asset owners transparent?
2. Are asset owners being treated fairly and consistently?
3. Are research costs passed through to asset owners “reasonable”?

⁴⁹ Healthy Markets Letter, at 12.

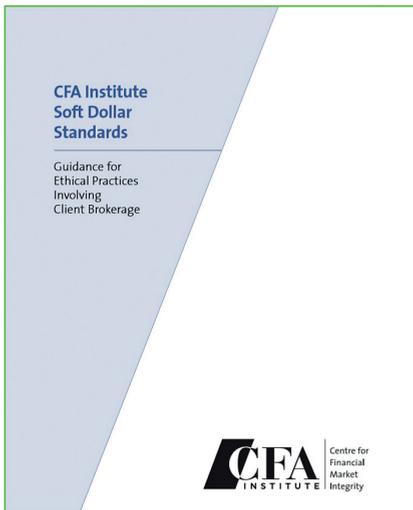
⁵⁰ See generally, Letter from Kenneth E. Benson, Jr., SIFMA, to Hon. Jay Clayton, SEC (21 March 2019). <https://www.sec.gov/comments/mifidii/cl15-5180413-183532.pdf> (March 2019 SIFMA Letter).

⁵¹ But see the Letter from Kurt Schacht, CFA Institute et al., to Hon. Jay Clayton, SEC (26 June 2019). <https://www.sec.gov/comments/mifidii/cl15-5739221-186727.pdf>.

4. Are bundled commission payments leading to an optimal amount of high-quality research?
5. What are the potential conflicts of interest, and what governance or disclosure rules are in place to mitigate these conflicts?

Are Research Costs Paid by Asset Owners Transparent?

Exchange Act Section 28(e), as described previously, does not impose a transparency requirement on investment advisers taking advantage of the safe harbor it provides. Nor has the SEC interpreted the statutory safe harbor as requiring advisers to disclose how much of their customers' assets are used to pay for investment research.⁵² Although overall transaction costs may be disclosed, the portion of commissions used to pay for qualifying research, as distinct from the portion used to pay for trade executions, is not typically disclosed.⁵³



For more than 20 years, the Standards have required members who are asset managers to “clearly disclose, with specificity and in ‘plain language,’” their policies relating to all soft-dollar arrangements, including disclosures as to whether the research may benefit clients other than the ones paying for it.⁵⁴ Furthermore, the Standards require adviser to disclose to their customers “(i) the types of Research received through Proprietary or Third-Party Research Arrangements; (ii) the extent of use; and (iii) whether any affiliated Broker is involved.”⁵⁵

In general, broker/dealer research providers may prefer to receive payment for their research in the form of increased trading and commissions. Doing so can create a conflict of interest for investment managers or investment advisers who, to ensure the continued flow of research, will direct more trading volume to certain brokers, thus bolstering the

⁵² See, for example, Letter from Russ Kinnel et al., Morningstar, Inc., to Hon. Jay Clayton, SEC (2 April 2019). <https://www.sec.gov/comments/mifidii/c115-5305997-183847.pdf> (Morningstar Letter).

⁵³ Morningstar Letter.

⁵⁴ CFA Institute, *Soft Dollar Standards*, at 8; Standard VI.A.1. The CFA Institute official positions relating to duties to clients reads: “It is the duty of investment managers to seek best execution for their clients, to ensure that any benefits accruing from the payment of commission fees beyond execution costs belong to the clients, and to inform their clients about how the benefits derived from those execution costs are invested.”

⁵⁵ CFA Institute, *Soft Dollar Standards*, at 8.

brokers' commissions and revenues. In contrast, the costs to asset owners arising from such bundled commission arrangements may exceed the explicit commissions for trading services and research because asset owners also may absorb higher costs from less-advantageous execution for the bundled trades.

One particularly challenging concern for many investment managers and investment advisers is the fact that many US-based broker/dealer research providers will not currently accept direct hard-dollar payments for research.⁵⁶ These brokers argue that if they were to accept hard-dollar payments, they would become subject to the Investment Advisers Act of 1940 (Advisers Act) and have to register as investment advisers—something they generally do not want to do.⁵⁷ One notable research provider got around this requirement by using an affiliated investment adviser to distribute its research.

The Hidden Costs Within Bundled Services

Before the No-Action Letters broker/dealers could not accept payment through any means other than trading commissions. As a result, investment advisers had to choose between obtaining research from broker/dealers to whom they were paying client commissions or rejecting those broker/dealers' research all together. In the case of the bundled services, the cost to the advisers' customers exceeds the cost of the actual research because it also includes the cost of the trade execution. But that is not the only additional cost.

Consider an adviser who values research as worth \$0.02 per share on a given trade. The “execution-only” commission rate charged by the broker research provider to the adviser is \$0.005 per share. But what if the execution cost for the trade with this broker is significantly higher than it might be with another? In this case, the adviser's dependence on the research product may lead to inflated overall trading costs for the asset owners. These additional costs do not show up as “commissions,” but they nevertheless are costs borne by the asset owners, and they exceed the explicit research costs.

Furthermore, what is an explicit “execution-only” commission rate is also questionable. For a broker/dealer, the apportionment of the two separate commission rates may be immaterial. It could be, however, quite material to an adviser, particularly if it is reimbursing asset owners for the portion of the overall commission attributed to research but not the portion for trade execution.

⁵⁶ See the February 2019 Capital Group Letter.

⁵⁷ See the March 2019 SIFMA Letter.

For example, if the bundled commission rate is \$0.04 per share, the broker/dealer research provider may not care about the ratio between the “execution-only” portion and the “research” portion. Conversely, an asset manager may have a strong preference, particularly if it is directly or indirectly absorbing the research costs, as are nearly all managers in Europe post-MiFID II implementation as well as several in the United States. In these instances, advisers may be incentivized to increase the portion of the overall commission rate identified as compensation for the trade execution.

Not surprisingly, it appears some execution-only commission rates may be rising. At the same time, some research providers in Europe appear to be offering their research at cut-rate levels, often at just fractions of the rates they accepted months earlier. Although some of this decline in rates may be a result of MiFID II-mandated research pricing transparency,⁵⁸ it also is likely that research providers will continue to expect compensation for their services.

Passing Along the Cost of Research

Many have speculated that research providers will be paid through increased trading, a conflict of interest that existed long before MiFID II. Furthermore, to the extent that European asset owners do not expect to pay for research, any increases in broker/dealer trading revenues is likely to come from bundled commissions arising from trading by non-MiFID-covered customers, such as US pension funds.⁵⁹ The SEC does not currently require sufficient transparency into research costs to allow asset owners to identify, let alone quantify, the extent to which this may be occurring.⁶⁰

Notably, the *2019 US Research Survey* from CFA Institute found that, since the beginning of 2018, when MiFID II and PRIIPs took effect, 37% of respondents reported that research costs had become “more transparent.”⁶¹ Moreover, 42% said the overall research market has become more competitive, with only 9% arguing it had become less competitive (figure 2).⁶²

⁵⁸ CFA Institute, *2019 US Research Survey*.

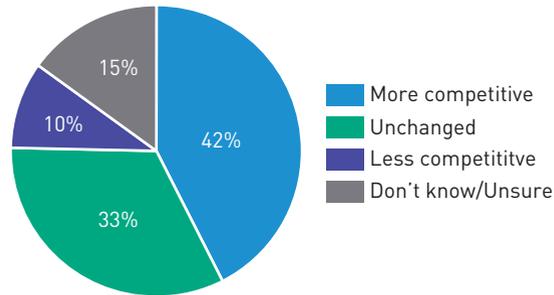
⁵⁹ Letter from Amy C. McGarrity, Colorado Public Employees Retirement Association, to Hon. Jay Clayton et al., SEC (31 January 2019). <https://www.sec.gov/comments/mifdii/cll5-4919382-178351.pdf> (January 2019 Colorado PERA Letter); see also the Healthy Markets Letter.

⁶⁰ Morningstar Letter; January 2019 Colorado PERA Letter.

⁶¹ CFA Institute, *2019 US Research Survey*.

⁶² CFA Institute, *2019 US Research Survey*.

FIGURE 2. SINCE JANUARY 2018, THE INVESTMENT RESEARCH MARKETPLACE OVERALL HAS BEEN -----



Member-respondents were seeing these positive developments even though the majority indicated they were not directly affected by the European rules. The ability to separately shop for research and trade execution, therefore, and to have those costs separately disclosed, ultimately could lead to an even-more competitive marketplace with different overall costs for research than bundled-commission arrangements have produced in the past. The question is whether the benefits of transparency in this case are greater than the benefits many see in the current structure.

Are Asset Owners Being Treated Fairly and Consistently?

A key question for asset managers and asset owners alike is whether research payment practices are fair. In particular, should an adviser use funds from one customer or set of customers to pay for research that benefits other customers? Some have argued that under this system, a fund adviser could decide to directly use the Client Brokerage generated on behalf of its mid-cap fund investors to pay for research benefiting its small-cap fund investors by "sending bundled trades to the broker/research provider for the pure mid-cap fund."⁶³

Such a scenario likely would be compliant with current interpretations of Section 28(e), as would a similar situation between investors in a developed market fund paying for emerging market research. To comply with the Standards, however, an adviser would need to appropriately disclose to its customers the details of this practice, including the effect on investors in the mid-cap fund. It also would, over time, need to ensure that the benefits reaped by the investors in the small-cap fund are repaid, either in-kind or in cash, to the mid-cap fund investors.

⁶³ Healthy Markets Letter, at 6.

This hypothetical is also instructive, however, when thinking about the rapid evolution of research payment practices in Europe compared with the United States. Many global asset managers are no longer using their European asset owners' commissions to pay for research, but many are continuing to use other asset owners' commissions to pay for research. Put simply, investment advisers potentially may be shifting their research costs to increasingly disadvantage their US customers.⁶⁴

In contrast, some global asset managers have opted to pay for all third-party research out of their own assets, as opposed to using client commissions. They have done so, in part, out of an expressed desire to have a globally consistent approach.⁶⁵

Are Research Costs "Reasonable"?

In the United States, the safe harbor for investment advisers using client commissions to pay for research requires those payments to be "reasonable."⁶⁶ The contours of "research" or "reasonable" costs have never been clearly articulated, however.⁶⁷ This lack of clarity in the United States contrasts sharply with the longstanding rules of the United Kingdom and more recent EU-wide MiFID II requirements, under which asset managers are expected to, among other things, precisely identify and value research consumed as well as detail how it benefits the asset owners who pay for it.

⁶⁴ January 2019 Colorado PERA Letter, at 3: "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, cross subsidized this manager's European clients, which benefited 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."

⁶⁵ See, for example, Richard Henderson, "How MiFID Has Made Its Mark in the US," *Financial Times* (7 May 2019), remarks of Marc Wyatt, T. Rowe Price. <https://www.ft.com/content/748bb6b8-6a77-11e9-80c7-60ee53e6681d>. See also Benjamin Bain, "Wall Street Braces for MiFID-Style Rules Descending on the U.S.," reflecting Capital Group, T. Rowe Price, and Sands Capital Management had or were in-process of implementing methods to pay for third-party research.

⁶⁶ 15 U.S.C. 78bb(e).

⁶⁷ See the 2006 Guidance and 2001 Guidance. Notably, the SEC has brought some enforcement cases against advisers for violations related to soft dollars used for items that could not reasonably be defined as "research" or for arrangements that were not adequately disclosed. See, for example, *In the Matter of Dawson-Samberg Capital Management*, regarding use of client commissions to pay for undisclosed personal travel and other expenses.

As an initial matter, asset managers should consider what constitutes “research.” Although the SEC has offered guidance to identify what may qualify as research under Section 28(e),⁶⁸ significant questions remain about what is permissible “research.” For example, under UK rules and MiFID II, so-called corporate access (e.g., arranged meetings with corporate executives) is not considered research that may be paid for using client commissions. In the United States, by contrast, such “corporate access” may include a significant portion of the research value paid for using client commissions.

Around the world, asset managers, asset owners, and regulators are questioning whether it is “reasonable” for an asset owner to pay for research that does not benefit that asset owner. As discussed, it is not viewed by the SEC as unreasonable for a fund to pay for research that does not benefit that fund in any way. In Europe, this is impermissible under MiFID II.

Additionally, asset managers should consider whether the costs passed through to their asset-owner clients are generally commensurate with the value of the research used. In this regard, the traditional research market poses many challenges.

The common practice of linking amounts paid for research to overall trading volumes raises significant questions about the reasonability of bundling of commission costs, particularly in instances in which brokers are paid for research in amounts that depend on trading volume but not on the defined value of the research provided.⁶⁹ It has been a common practice for asset managers to allocate their broker selection and “commission wallets” based on predetermined percentages of total trading. As the managers’ trading volumes fluctuate, so too do the commissions paid. The ethical question for managers in these cases, however, is whether they have procedures in place to mitigate the conflicts of interest that may affect trading decisions, and the need to disclose those conflicts and procedures to their clients.

To date, the SEC has not interpreted Section 28(e) as requiring the amounts paid for research be explicitly linked to the quantitative value of the research provided. This leads to significant potential variations in research payments based on factors not related to the

⁶⁸ See the 2006 Guidance and 2001 Guidance.

⁶⁹ Many asset managers engage in a voting practice wherein traders and portfolio managers 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 ratios based on some calculations. Alternatively, a portfolio management strategy usually calculates expected turnover in advance, with estimated annual commission costs based on fund size and expected turnover. From this, a specific dollar value, rather than a proportion of the commission budget, for each broker can be set in advance and regularly updated based on the value of both research and execution. Additional inflows might allow a manager to add another broker that provides excellent research and execution in a specific niche or sector, rather than allocate more money to the same brokers already used.

value of that research. For example, significant asset inflows could cause managers to double trading volumes, potentially leading to their asset-owner customers having to pay twice as much for research. Likewise, in a bull market, the amount paid for investment research will rise because commissions are directly tied to the values of the assets being evaluated. This latter example occurred in pre-MiFID 2017, when many European asset owners saw their commission payments rise commensurate with a significant rise in European asset prices.⁷⁰

Alternatively, advisers experiencing investor outflows, or those whose strategies dictate less frequent trading, may see their trading volumes decrease, leading to smaller commission payments for their brokers. Similarly, commission payments may decline when research leads to decisions not to trade. In these instances, the research provided may be of significant value to the asset manager, but the reduced payments may not reflect its free-market value.

Complicating matters, in many instances, is that broker/dealer research providers have not shared explicit prices for research. Put simply, the service provider does not make explicit what it expects to be paid for its service. In such situations, asset managers may utilize internal or third-party solutions to ascertain the value of the research provided and consumed. Not surprisingly, however, since the advent of MiFID II, the offerings available to asset managers to identify, track, value, and pay for research have proliferated.⁷¹

Are Bundled Commission Payments Leading to an Optimal Amount of High-Quality Research?

Market participants, regulators, and lawmakers have repeatedly expressed concerns regarding whether enough high-quality research is being produced and consumed. Given that nontransparent, bundled commission practices have dominated the global marketplace for some time, it is appropriate for interested parties to explore whether alternative models may lead to different results. In fact, when adopting MiFID II, European regulators explicitly stated the opinion that separating research and trading decisions could lead to more competition in the research market, including the development and proliferation of independent research providers. Alternatively, the industry has recognized the additional likelihood that large asset managers would hire the best research analysts for their own in-house teams, thereby removing the best competitors from the research market.

⁷⁰ Healthy Markets Letter.

⁷¹ See, for example, IHS Markit, *MiFID II Solutions*, at 8. <https://cdn.ihs.com/www/pdf/MiFIDII-update3-separatecover-final.pdf>.

This is a somewhat intuitive result, particularly given that specialized, independent research providers may have limited trading capabilities. Because these research providers typically are paid directly by asset managers, as opposed to indirectly from asset owners' commissions, many asset managers may opt to obtain research elsewhere. Asset managers in these circumstances must choose between (a) research from full-service broker/dealers who require bundled client commissions for research, execution, and other services; and (b) unbundled research from independent firms paid out of their own assets, with execution provided by a broker/dealer.

Asset managers—particularly smaller firms—may have difficulties absorbing these additional costs, and so they may be incentivized to obtain research from and trade with the full-service broker/dealers—despite potentially higher costs or inferior quality of research or execution.

Nevertheless, some market participants and regulators have argued that changes to research payment practices will reduce the availability of research on small and midsize companies.⁷² This argument adopts an assumption underlying the SEC's recent tick-size pilot program, in which "excess" commission revenues from trading in other funds were expected to subsidize more research on these companies. The pilot failed to produce more research, as many market participants predicted.⁷³ The issue raised earlier about whether asset owners in a large-cap fund should have to subsidize research costs for a small-cap fund in which they are not invested also applies.

Moreover, significant questions remain about the underlying premise that bundled research payments are now providing a wealth of small- and mid-cap research. This runs counter to the view of many market participants who have lamented the dearth of research into small companies. It turns out a significant portion of the research into small issuers is provided by smaller, independent research firms.

Thus, it was predicted that large, full-service research providers would experience significant reductions in the prices their customers would be willing to pay in the post-MiFID II world. That seems to have happened. In the United Kingdom, the FCA found that "research budgets have been reduced by around 20–30%," and asset owners' costs for

⁷² See, for example, Remarks by Hon. Jay Clayton, SEC before the Investor Advisory Committee (28 March 2019). <https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-032819>.

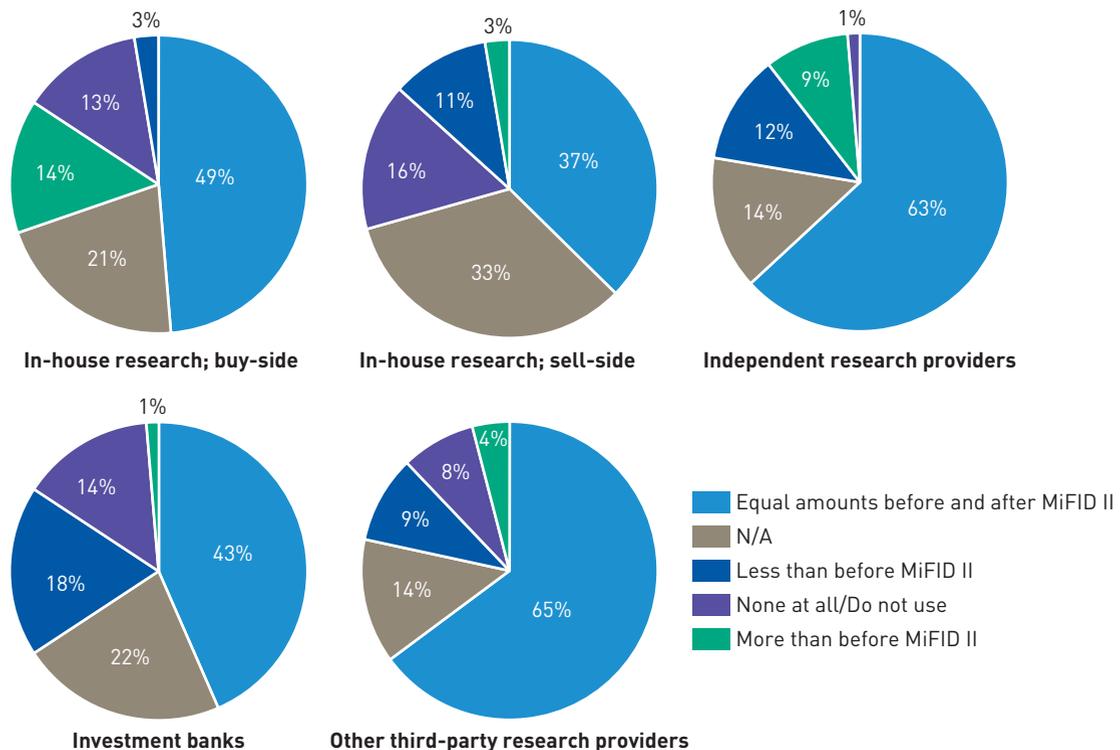
⁷³ See the SEC Investor Advisory Committee, "Recommendation of the Market Structure Subcommittee: Decimalization and Tick Sizes" (31 January 2014). <https://www.sec.gov/spotlight/investor-advisory-committee-2012/decimal-pricing-draft-recommendation-iac.pdf>. The Subcommittee noted, "Most retail order flow today is forwarded to the market center with the best overall execution in that stock or class of securities...If tick sizes increase, it seems highly likely that any additional profits will simply be retained by these trading centers or shared with firms that send them order flow, rather than being directed into increased research or other activities to benefit capital formation."

“equity portfolios managed in the UK” had fallen approximately £180 million (approximately \$235 million) during 2018.⁷⁴

Although overall research spending may have decreased in recent years, likely driven by the European rules changes and competitive pressures, where research is obtained also may be changing significantly.

In particular, asset managers seem to be increasingly turning to in-house and independent research sources as a consequence of MiFID II. According to the CFA Institute *2019 US Research Survey*, for example, 15% of buy-side respondents said they were getting more research in-house than before 2018, compared with 3% who said they were using in-house research less (figure 3).

FIGURE 3. FOR EACH OF THE FOLLOWING RESEARCH PROVIDERS, HOW MUCH RESEARCH DO YOU SOURCE COMPARED TO BEFORE MIFID II?



⁷⁴ Remarks of Andrew Bailey, FCA.

Respondents did not see much change in their use of research from independent (63%) and other third-party (65%) sources. Still, 9% said they planned to increase their use of independent sources in the coming year, compared with 12% who said they were using independent providers less than before 2018. Other third-party sources were seen receiving greater sourcing from just 4% of respondents, versus 9% who used less than before MiFID II.⁷⁵

The biggest declines in research usage were seen for investment bank research, according to the survey, of which 18% of respondents said they were using less than before MiFID II. Just 2% said they were using this source more frequently.⁷⁶

That said, the ultimate outcomes of MiFID II and current changes in research practices are not yet fully known. As these reforms occur, asset managers should consider their research usage and evaluate potential changes to enhance their research procurement, consumption, and payment practices.

Analysis and Recommendations

Implementation of MiFID II and PRIIPs in Europe has sparked significant regulatory conflicts and changes to investment industry practices around the world. Reconciling the different regulatory and customer expectations has proven challenging for many market participants. Changes to longstanding research practices are disrupting business models for asset managers, investment advisers, and research providers, and potentially are exacerbating the dearth and decline in research on small public companies.

As noted at length, the ban imposed by MiFID II on the use of soft commissions or bundled brokerage as a means for asset managers to acquire investment research created a key conflict with the Advisers Act, adopted into US law in 1940. The SEC's 2017 No-Action Letters temporarily relieved asset managers, investment companies, and broker/dealers of obligations that conflict with MiFID II but left for later long-term solutions to the conflicts raised.

Resolution of these matters will require deft reconciliation of a number of conflicts within the investment world. For one, it will have to consider the current state of the investment research market, as well as how regulations may bolster or upset and potentially undermine competitive balance within the US investment management and broker/dealer sectors. Initial reaction in Europe to the wholesale move to hard-money payments for

⁷⁵ CFA Institute, *2019 US Research Survey*.

⁷⁶ CFA Institute, *2019 US Research Survey*.

investment research has been dramatic within all parts of the industry. Large asset managers, capable of easily absorbing research costs, have, in many cases, drastically altered their research purchases.⁷⁷

Anecdotal evidence indicates that the situation for smaller European asset managers is grimmer. As indicated in a survey of CFA Institute members in the European Union one year after MiFID II's implementation,⁷⁸ small and midsize firms endured dramatic changes in payment sources for research between 2017 and 2018. Use of Client Brokerage fell to 14% of respondents with AUM below €1 billion, from 25% in 2017. Over the same period, the percentage of managers paying cash for research rose to 65% in 2018, from 42% a year earlier. Similar, although less dramatic, changes were seen for firms with AUM up to €250 billion. Virtually no very large firms were seen using Client Brokerage in 2018.

Comments from one US midsize research provider show how this has affected research providers in the EU post-MiFID II implementation. The US firm noted that an EU asset manager/client cut payments for research to the US firm to \$50,000 in 2018, from \$1 million the year before. Moreover, the EU firm no longer can access the research provider's analysts, buy its research, or even visit with covered US companies when visiting in Europe. While noting a recognition of going too far in research reductions, the asset manager increased its research budget to buy the output of the US provider to \$100,000 per year, still just 10% of the pre-MiFID II environment.

Looking ahead, lower investments in research by small and midsize asset managers of the type noted previously has significant potential to hurt investment performance for managers and their clients over time. Ultimately, deliberate underinvesting in research may upset the competitive balance in Europe as such managers fall further behind large firms with their teams of in-house research teams. Likewise, independent and brokerage research providers are recognizing the improbability of returning to the demand for their work present in the period before MiFID II's implementation.

⁷⁷ See Josephine Mason, "BlackRock and Peers Slash Research Budgets as New EU Rules Squeeze Brokers," Reuters (11 December 2018). <https://www.reuters.com/article/us-eu-markets-mifid/blackrock-and-peers-slash-research-budgets-as-new-eu-rules-squeeze-brokers-idUSKBN1OA1OZ>.

⁷⁸ CFA Institute, "MIFID II: One Year On: Assessing the Market for Investment Research" (2019). <https://www.cfainstitute.org/-/media/documents/survey/cfa-mifid-II-survey-report.ashx>. Figure 4 shows the changes in payment mechanisms for research between 2017 and 2018.



US Choices

For US broker/dealers, decisions for the future depend to a large extent on the decisions the SEC will make about how to resolve the rules conflicts with Europe. Primary among these decisions is whether to permit these entities to accept hard dollars for investment research without having to register as investment advisers.

How the SEC decides this question will have even greater influence on asset managers' futures. Assuming the SEC retains the Section 28(e) safe harbor, allowing managers to buy research using Client Brokerage, the most difficult decisions will face small and midsize asset managers if the SEC permits hard-dollar payments for research. Although hard-dollar purchases of research are not unheard of in the United States, according to the CFA Institute survey of US members, currently just one-third of asset managers indicated they exclusively pay for their own research in that way.⁷⁹ By comparison, a significant plurality in the survey (44%) indicated they use either Client Brokerage arrangements exclusively (18%) or some combination of hard dollars and Client Brokerage (26%) to purchase investment research. Before MiFID II implementation in the EU, the combined percentage of respondents using Client Brokerage only (22%) and in tandem with cash (11%) was just 33% for small asset managers.⁸⁰

Absorbing all research costs, while a relatively small expense for very large asset managers, poses serious challenges for small and midsize asset managers, and the primary strategies for operating in such an environment come with significant competitive risks. One would be to adjust the amount of research managers purchase to a level they believe optimally balances the need to earn competitive returns with income statement management. Lower profitability, in other words, is paired against experimentation in the right amount of research needed to remain viable in the market.

Alternatively, firms could attempt to maintain their research investments by passing along the costs through higher fees charged to clients. The feasibility of this strategy, however, would rely on superior performance, made more difficult in an environment of pricing pressures created by a combination of technological platforms, index-based exchange-traded and mutual funds, and very large firms.

Research providers, too, face changes, although not all appear as difficult as those facing smaller asset managers. An SEC decision to permit broker/dealers to sell research for cash without having to register as investment advisers would benefit research teams affiliated with

⁷⁹ CFA Institute, *2019 US Research Survey*.

⁸⁰ "MiFID II: One Year On," figure 4.

broker/dealer firms by expanding the market in which they can sell their insights. At the same time, however, it would raise the level of competition in hard-dollar research for independent research providers. In the long run, however, good research will eventually find buyers—that is, as long as the buyers find the research before the provider goes out of business.

One final area of concern is how any rule changes will affect the creation and availability of research covering small and midsize listed companies (SMEs). Such concerns are not new and were raised at least as long ago as the mid-1970s. Nevertheless, the noted effects of MiFID II on SME coverage in Europe postimplementation has captured the attention of European policy makers and likely will garner attention in the United States as well. In the CFA Institute survey of EU members, 53% of sell-side respondents said small- and mid-cap equity research had decreased during 2018, 12 percentage points greater than the perceived decline in emerging markets research during the same period.⁸¹

Overall, the regulatory changes in Europe have not won glowing praise from the industry, either within the EU or outside of it—in particular, in the United Kingdom and Switzerland. When asked about whether MiFID II has delivered better overall outcomes for end-investors, 55% of EU members said no, compared with 23% who said yes or expressed uncertainty. Respondents in Switzerland were more negative, with 59% saying end-investors were worse off, while UK members were the most negative, with 66% saying no, versus just 13% who said yes.⁸²

Recommendations

On the basis of this discussion about the legal and regulatory issues facing the SEC, along with the potential effects any changes may create for US market participants, CFA Institute believes the following Commission and industry actions would lead to the best outcome for investors, and therefore, ultimately for the financial services industry.

To standardize and improve industry practices, CFA Institute recommends the SEC mandate that asset managers: (1) disclose the cost of research they have purchased through Client Brokerage arrangements in the prior period on behalf of their asset-owner clients; and (2) ensure that the asset owners who pay for research using Client Brokerage will ultimately benefit from such research investments over a relatively short time period.⁸³

⁸¹ “MiFID II: One Year On,” figure 9.

⁸² “MiFID II: One Year On,” figure 13.

⁸³ CFA Institute, *Soft Dollar Standards*.

We note that SEC Commissioner Robert J. Jackson, Jr. has explicitly called for similar reforms.⁸⁴

We also recommend that the SEC adopt guidance to allow broker/dealers to accept cash for research without having to register as investment advisers. Given the regulatory bind not doing so would create for these firms, along with the increased research options the change would potentially create for asset managers, we believe it is appropriate for the Commission to make this change.⁸⁵

CFA Institute recognizes the potential conflicts of interest Client Brokerage arrangements create for asset managers, and we are well aware of the discordant views about the perceived costs and benefits of these arrangements.⁸⁶ Given the strong and convincing arguments available on both sides of this issue, we do not believe it is appropriate for the Commission to interfere in the ability of market participants to legally contract with each other. One reason for this view is that such regulatory intrusions often overlook the potential unintended consequences produced in which market participants attempt to adhere to and balance regulatory and business imperatives. Moreover, as long as asset managers adhere to, and the Commission enforces, the previously stated recommendations about cost disclosure and assurance of benefit from Client Brokerage arrangements, and to the extent that the negotiating parties benefit from a high degree of information symmetry and market position, such regulatory intrusion is not needed.

Beyond this, we also recommend that asset managers adopt and implement policies and procedures that move toward separating research procurement from trade execution and other products and services where possible and in the best interests of their clients. Increasingly, the business of providing high-quality research is distinct from the business of providing high-quality trade execution. And as the investment industry has become

⁸⁴ Remarks of Hon. Robert J. Jackson, Jr., before the 2019 Healthy Market Structure Conference (11 June 2019).

⁸⁵ See CFA Institute, *2019 US Research Survey*, finding that 60% of respondents believed the “SEC should revise its rules to permit brokers to accept hard dollar payments for research in the United States.”

⁸⁶ See, for example, Stephen M. Horan, CFA, and D. Bruce Johnson, “The Welfare Effects of Soft Dollar Brokerage: Law and Economics,” The Research Foundation of the Association for Investment Management and Research, now the Research Foundation of CFA Institute (May 2000). <https://www.cfainstitute.org/-/media/documents/book/rf-publication/2000/rf-v2000-n1-3910-pdf.ashx> The authors argue that the desire to build long-term relationships may lead to brokers giving higher-quality research and recommendations to loyal asset manager clients. A contrasting view is provided by John C. Bogle “The End of “Soft Dollars?” *Financial Analysts Journal* 65, no. 2 (2009), 48–53, DOI: 10.2469/faj.v65.n2.1, <https://doi.org/10.2469/faj.v65.n2.1>. Bogle concluded his article: “Ultimately, the era of soft dollars, for marketing and research alike, must come to an end, simply because soft dollars ill serve fund investors. The end of soft dollars cannot come too soon.”

increasingly specialized, market participants should seek the best investment research and execution services available from sources that offer such services on the most cost-effective terms.

We further recommend that the Commission consider investor outcomes rather than specific costs when determining whether an investment manager or adviser has achieved best execution for its clients.

Finally, to implement these recommendations, we urge the Commission to revise interpretations of Section 28(e) and such other rules and guidance as is necessary and appropriate for asset managers to implement these recommendations.

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